Abstract: Widely-used predictors of financial distress, such as Altman’s Z score, utilize financial ratios and indicators drawn from company financial statements. Such predictors may perform poorly when the financial statements themselves have been doctored in a major financial fraud. This paper explores other predictors, both qualitative and quantitative, which might be used as “red flags” of major fraud. We identify ten publicly traded companies in Europe and the United States which experienced major financial fraud involving allegations of misconduct at the highest corporate levels, and seek to identify common features which could be publicly observed in the 2-3 year period prior to the discovery of the fraud. The following features appear reasonably frequently in the sample: (1) domination by an individual or small group; (2) massive growth; (3) operational mystery; (4) easy access to capital with poor monitoring or controls; (5) unnecessarily complex corporate structure; (6) unusual or substantial involvement in currying influence with politicians; (7) lavish expenditures; (8) significant run-up in share price in the years before the fraud was discovered, and (9) significant volatility in share price in the period shortly before the fraud’s discovery. Taken together, these features may be used as an index of the risk of major fraud in public corporations, and may have a bearing on the potential liability of auditors, attorneys, accountants, and others whose professional roles may require them to be sensitive to the possibility of serious misconduct by senior managers of publicly traded companies.

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Introduction

Widely-used predictors of financial distress, such as Altman’s Z score, utilize financial ratios and indicators drawn from company financial statements. Such predictors, accordingly, may perform poorly when the financial statements themselves have been doctored in a major financial fraud. The potential shortcomings of financial statement analysis suggest the utility of utilizing other indicators for identifying fraud risk in public companies.

This paper identifies ten publicly traded companies in Europe and the United States that experienced serious financial fraud, with allegations of involvement by top corporate managers, in the period 1995-2005. The companies are Adelphia Communications, Computer Associates, Enron, Health South, Global Crossing, Lernout & Hauspie, Parmalat, Royal Ahold, Vivendi Universal, and Worldcom.

Based on these case histories, we examine whether the firms in the sample manifested “red flags” of fraud risk during the two to three year period prior to the fraud being uncovered. We identify features, both quantitative and qualitative, which were present in a significant majority of the firms in the sample. We suggest that these features may help identify firms that are subject to a risk of catastrophic losses due to frauds committed or sanctioned by high level management personnel, and investigate whether the presence of these factors, if known or reasonably apparent to a defendant, might be relevant to a determination of liability against an auditor, accountant, attorney, or other person whose professional role involves screening against the possibility of misconduct within a publicly traded firm.
I. Approaches to Fraud Risk

Identifying risk of corporate distress is a priority for well-functioning financial markets. Several methodologies are currently used to assess bankruptcy risk based on publically available accounting data. Altman’s Z score\(^2\) evaluates risk of corporate bankruptcy based on five financial ratios found to have predictive value when analyzed against a sample of failed and non-failed firms using multiple discriminant analysis\(^3\). Zmijewski’s X probit model\(^4\) uses net income/total assets; total debt/total assets; and current assets/current liabilities as explanatory variables. Ohlson’s Y model employs logistic analysis based on measures of firm size, leverage, liquidity and performance.\(^5\)

These models provide good predictions of bankruptcy risk. However, each is subject to limitations. Altman’s sample of manufacturing firms may not carry over to firms in service industries, for example. There is also no intrinsic reason to believe that the parameters generated in the various studies have remained constant over time.\(^6\) Most importantly for present purposes, the accuracy of accounting-based measures obviously depends on the accuracy of the data from which these indices are calculated. This fact suggests that these measures will not necessarily be good predictors of financial distress when the corporate insiders have been covering over problems (or perhaps causing them) by cooking the books. If the financial accounting is inaccurate, accounting based

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\(^3\) Discriminant analysis determines whether the means of variables are significantly different across groups. Altman’s variables are: working capital/total assets; retained earnings/total assets; earnings before income and taxes/total assets; market value of equity/total liabilities; and net sales/total assets.


measures are obviously problematic as well. Thus, none of these measures specifically assesses the risk of financial distress due to fraud.

Other studies look beyond financial statements to evaluate bankruptcy risk, and thus potentially avoid some of the problems associated with accounting-based measures when fraud is present. Several researchers utilize market values of equity in an option-pricing model which, in theory, incorporates all publicly available information about bankruptcy – not only accounting information.\(^7\) The motivation behind these studies is that they include relevant information beyond that contained in accounting statements alone. These studies may also be more effective than accounting-based measures at assessing the risk of financial distress due to fraud, since market traders may be privy to information or rumors from inside a company which are edited out of the company’s public reports of condition. However, studies that look at share price alone exclude other relevant information that may be pertinent to assessing the risk of serious financial fraud.

Auditors may be somewhat better positioned than external observers to assess fraud risk because they look behind the financial statements and review the internal processes at the firms they review. Statement of Auditing Standards 99\(^8\) sets forth a comprehensive set of procedures and standards for external auditors to use in identifying fraud risk. The standard identifies a “fraud triangle” of common features that generally are present before a major financial fraud can occur: an incentive or pressure providing a reason to commit fraud; an opportunity for fraud to occur, and an attitude on the part of the perpetrators that allows them to rationalize their misconduct. The standard requires

\(^8\) Auditing Standards Board of the American Institute of Certified Public Accountants, Statement of Auditing Standards 99 (effective 2002).
auditors to engage in “brainstorming” sessions with senior management to discuss how and why the financial statements might be susceptible to fraudulent manipulation, and requires auditors to gather information that may have a bearing on fraud and to use that information to identify risks of fraud leading to a misstatement. Auditors are required to evaluate the firm’s internal risk-management procedures, to continuously assess the risk of fraud during and at the conclusion of the audit, and to communicate any evidence of fraud to senior management and others.

Of particular relevance to the present article, SAS 99 adopts a “red flag” approach to financial fraud. The standard sets out a list of 42 indicators that the auditor must consider during the course of the external audit. The SAS 99 approach is useful for auditors, but less so for others, such as investors, regulators, analysts, and compliance officials, because it is specifically crafted for the context of the external audit. Many of the 42 red flags in SAS 99 are only observable by the auditors (e.g., domineering management behavior in dealing with the auditor, or frequent disputes with prior auditors). Other information potentially relevant to assessing fraud risk, such as the price performance of the company’s stock, is not included in the SAS 99 checklist because it is not a subject of inquiry during the external audit. However, SAS 99 does identify several warning signs of financial fraud that are publically observable and that, as discussed below, do seem to correlate with enhanced risk of major financial fraud: rapid growth or unusual profitability; recurring negative cash flows from operations; significant related-

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10 The 42 red flags are set out in the appendix.
party transactions not in the ordinary course of business; domination of management by a single person or small group; and overly complex organizational structure involving unusual legal entities or managerial lines of authority. As yet, therefore, there appears to be no generally accepted methodology for assessing fraud risk outside the specialized context of the audit function.

II. Case Studies

This section presents brief vignettes outlining key events and circumstances surrounding ten significant financial frauds in Europe and the United States. Our selection criteria for these cases were as follows. We required that the company be publically traded, there be a serious financial fraud or substantial allegations of financial fraud, that the fraud or allegations involve misconduct by highly placed managers (at least the level of the chief financial officer), and that the fraud be associated with the failure of the firm or massive losses in share price. We restricted our sample to frauds committed between 1995 and 2005. While the selection criteria inevitably involved the exercise of judgment, we believe that the ten cases which we ended up investigating represent most or all of the major instances that satisfy the criteria of our search.

Adelphia

Adelphia’s dizzying rise began in 1952 when John Rigas, who owned a movie theater, purchased a cable company in Coudersport, Pennsylvania for $300 – apparently as a hedge against loss of sales to television viewers. Rigas and his brother Gus incorporated Adelphia Communications Corporation in 1972. The company went public in 1980. John Rigas bought out his brother in 1982 and thereafter ran it as a personal family business.
The company – named Adelphia to celebrate the Rigas’ Greek heritage, was always run as a family business, with numerous family members occupying key managerial roles, including John Rigas’ sons Timothy J. Rigas, Michael J. Rigas, and James Rigas, and Peter Venetis, his son-in-law, all of whom had board seats at the company. During the period of the fraud, the family controlled five seats on the board of directors, with four seats being held by independent directors. However, the Audit Committee was staffed only by independent directors.

Adelphia’s rise and fall is intimately connected with the history of the cable television industry, which grew enormously after legal restrictions were lifted in the 1980s. The Telecommunications Act of 1996 enhanced the prospects of the industry further by requiring that as of 1999 rate regulation for cable content other than basic service packages would be eliminated. At the same time, economies of scale dictated progressive consolidation in the industry, culminating in a massive wave of mergers and acquisitions in 1999. Adelphia was quick to capitalize on these changes by accelerating its expansion through acquisitions. It completed three major acquisitions in 1999: Harron Communications ($1.2 billion), FrontierVision Partners ($2.1 billion), and Century Communications ($5.2 billion). It continued acquiring companies in 2000 and 2001. At its peak in 2000 Adelphia was the sixth largest firm in the industry.\textsuperscript{11} Between 1986 and 2002 Adelphia made 47 acquisitions and acquired major stakes in two other companies.\textsuperscript{12}

Although always a family affair, Adelphia was effectively dominated by John Rigas. Rigas was to some extent a larger-than-life figure. In addition to his interest in the cable company, Rigas purchased a controlling interest in the Buffalo Sabres ice

\textsuperscript{12} See http://www.alacrastore.com/mergers-acquisitions/Adelphia_Communications_Corporation-1000227.
hockey team. He reportedly relished his position as a prominent entrepreneur, served on numerous boards of directors, required that his image be broadcast at least once during every telecast of a Sabres home game, gave lavishly to charity, purchased homes for people in need, and flew sick people for treatment on his private jet. His personal lifestyle was ostentatious: he owned several luxury jets and multiple homes. He was, apparently, equally profligate with the company’s money: he constructed a palatial headquarters and a world-class 18-hole golf course in Coudersport, a town in North Central Pennsylvania with a population of about 2,500 souls.

Between 1997 and 1999, when Adelphia was growing at a massive pace, its common stock experienced a meteoric rise. In two-year period beginning in July 1997, its common stock rose from around $6/share to a peak close to $90/share. The huge run-up in its stock value facilitated Adelphia’s acquisition program, which often involved payment for assets with a combination of stock and cash. The fraud at Adelphia was effected through a remarkable simple strategy. Rigas established a central corporate account into which revenues from the public company were transferred. At the same time, he set up a complex web of private cable companies and other family-owned businesses which entered into “co-borrowing” arrangements with the public company, the effect of which was to allow the family entities to borrow in Adelphia’s credit. These family-owned entities then engaged in substantial fraudulent transactions the effect of which was to siphon money out of the public company’s account and into the control of Rigas family entities. Through this device, Rigas essentially used Adelphia funds as his family bank account, using them to pay for items such as the purchase of apartments for his private use, cash advances to the Buffalo
Sabres, and more than $250 million in margin calls on personal loans secured by the family’s interest in Adelphia stock.

The fraud at Adelphia accelerated and then unraveled as the telecom bubble burst in 2001 and 2002. Eventually, as the company’s debts and losses mounted, the managers resorted to sham transactions and other devices to inflate earnings and disguise poor results from operations. The company was delisted from NASDAQ after it failed to file its 2001 10K, and filed for bankruptcy on June 25, 2002. John Rigas and one of his sons were found guilty of conspiracy, bank fraud, and securities fraud, and are now serving time in federal penitentiary. They forfeited $550 million in cash and stock to the federal government. Adelphia’s auditor, Deloitte & Touche, apparently failed to discover the frauds at a time when the worst harm could have been prevented.

**Computer Associates**

Computer Associates, today called CA, is a Delaware corporation based in Islandia, New York. Its co-founders were Charles Wang and Russell Artzt. In 1981 the company went public and its shares were listed on the New York Stock Exchange.\(^{13}\) Under the firm command of Wang and his protégé, Sanjay Kumar, the company became the world leader in information technology management systems, growing rapidly through a massive, protracted acquisition program. The company acquired around 85 companies in the 1980s and 1990s.\(^{14}\)

In 1995 the shareholders accorded to Charles Wang, CEO, Sanjay Kumar, President, and Russel M. Artzt, Executive Vice-President, a Key Employee Stock Ownership Plan (KESOP) containing an accelerated vesting provision, entitling the three

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\(^{13}\) The company has recently announced its passage to the NASDAQ.

\(^{14}\) SLC Report, p. 4
men to get a total of 20 million shares if the company’s stock stayed above $ 53.33 for sixty days in a twelve month period.\(^{15}\) In the ensuing three years the company continued its unrelenting, successful acquisition campaign,\(^{16}\) and on May 21, 1998, CA’s share price closed above the target price for sixty days in a twelve month period, thereby triggering the accelerated vesting provision.\(^{17}\) Wang got more than 12 million shares, worth $ 670 million; Kumar and Artzt shared $ 447 million each, in one of the largest payments to corporate executives ever declared by a US public company.

After only 60 days, on July 21, CA issued a press release warning that its growth was slowing because of the Asian crisis and announcing its first-quarter report, which showed a $ 675 million after-tax charge to pay the three executives, equaling 43% of Computer Associates’ whole net income for the three previous years. As a Business Week’s article of the period reads, “[b]efore the charge, the company earned $ 194.2 million; after the charge, it lost $ 480.8 million.”\(^{18}\) The day after, July 22, 1998 the share price dropped by 31%.\(^{19}\)

As Computer Associates’ Special Litigation Committee Report has observed in 2007, the timing of these events was troubling: “Had CA’s management ‘learned’ of this information sixty days earlier, and had it promptly disclosed to the market … the KESOP would not have vested on May 21, 1998.”\(^{20}\)

The timing was troubling indeed. The board was not happy with E&Y’s final advice (expressed after some changes of mind) that the charge had to be recognized on

\(^{15}\) At the time of the July 6, 1995 Proxy Statement in which the KESOP was proposed to CA’s shareholders, Mr. Wang owned approximately five percent of CA’s outstanding common stock.


\(^{19}\) Ibid.; SLC Report, p.25.

\(^{20}\) SLC Report, p.25.
the day in which the target was reached and therefore in the quarter referred to in the July’s press release. In 1999, after having acquired Platinum Technology International Inc., Computer Associates dismissed Ernst & Young and hired KPMG L.L.P., asserting that KPMG was Platinum Technology’s auditor and the CA had established good relations with the firm while the purchase was closing. In truth the board was at ease no more with E&Y after the KESOP problem.

A derivative suit and a series of class actions started after the July 22, 1998 price collapse. CA’s General Counsel presented them to the board as typical “strike suits”. The outside accountants did not ask any investigation of the matter; accordingly the board did not take any further action to understand whether the suits had some merits.

In March 2000 the company reported profits of $696 million on sales of $6.1 billion. Computer Associates had increased fivefold over the last ten years and had a market value of $20.3 billion. This was the year in which Wang and Kumar bought the New York Islanders hockey team. However, the company’s credibility was low after the

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23 SLC Report, p. 158-159.
24 The SLC Report does not think that the issue constituted a “red flag” of the unlawful revenue recognition practices that were disclosed with the criminal investigations: “Nonetheless, even with the filing of these lawsuits (which did not allege the premature booking of revenue), there was still no ‘red flag’ waving in the face of the Board, which they intentionally ignored” (SLC Report, at 317). Reading the E.D.N.Y., *In re Computer Associates Class Action Securities Litigation*, 75 F. Supp. 2d 68, raises doubts about this conclusion. Indeed, the plaintiff’s position as described by the court was precisely mentioning unlawful revenue recognition:

"Plaintiffs claim that in order to restore the sagging value of CA stock, and therefore protect the stock interests of the individual defendants as provided under the 1995 Plan, CA began taking steps to artificially inflate its reported revenues and thereby conceal the deteriorating state of CA's business. (Am. Compl. P 47.) Although general accounting procedures "provide that revenues should not be recognized until they are realizable, earned and the collection of the sales price is reasonably assured," CA allegedly recognized revenue from the sale of software on credit terms extending as long as 10 years. (Am. Compl. PP 82, 86.) CA also offered customers excessive discounts, placed an unusual amount of pressure on its sales force to "book" sales, and engaged in "improper revenue recognition practices that artificially inflated" CA's operating results. (Am. Compl. P 47.) According to plaintiffs, each of these practices front loaded sales both before and during the class period at the expense of future periods, thereby hiding CA's poor earnings prospects [**7**] while at the same time safeguarding the individual defendants' interests under the 1995 Plan.”

The court denied CA’s motion to dismiss. The SLC adds that should an investigation been launched, it would have not touched revenue recognition practices, for which no allegations were made by the plaintiffs. From the quoted passage it seems that these allegations were made indeed.
KESOP affair. Results below the expectation were announced on July 3, 2000 and the stock fell nearly 40 percent when the markets reopened on July 5. The press reported that analysts were worried that the company was facing business troubles and was trying to sort them out through accounting gimmicks.26

On October 25, 2000 the company announced a new software licensing model. This new business model was heralded as one of the causes of the excellent Q4 results announced in April 2001 (the news release was titled “New Business Model Rules; Q4 Rocks”).27 The stock, after a long decline started in January 2000, rebounded. However, the hyped new business model did not convince everyone. On April 29, 2001 a long, very detailed article by Alex Sorensen, a New York Times financial reporter, was featured on the Sunday edition of the newspaper. Sorensen reported that

much of the growth that has enriched Mr. Wang was a mirage, according to more than a dozen former employees and independent industry analysts. Computer Associates, they say, has used accounting tricks to systematically overstate its revenue and profits for years. The practices were so widespread that employees joked that C.A. stood for ‘Creative Accounting,’ and that March, June, September and December, when fiscal quarters end, had 35 days, giving the company extra time to close sales and book revenue.

According to the accusations, the acquisitions were the prerequisite of the most significant accounting manipulations committed by Computer Associates, as the software giant allegedly extended the agreements in place between the target company and its customers in order to re-classify the former maintenance fees of the target as license fees

26 Alex Berenson, Despite strong sales, supra nt. ___, who wrote: “Luckily for Computer Associates, which is based in Islandia, N.Y., its earnings report lacked a place for it to disclose another important number. That would be the company's credibility with investors and analysts, which hovers near zero after years of missteps.”
27 Ibid.
and book them as instant revenues.²⁸ Since the pool of potential targets had been exhausted in 2000, CA had now to reinvent itself in order to survive. The company therefore introduced the new business model merely as an excuse to depart from the GAAP and adopt a different accounting system. Under this new accounting method the company results looked excellent; however, under GAAP rules the company results seemed poor²⁹ and analysts were reported to be unable to reconcile the pro forma results with the GAAP numbers.³⁰

Kumar presented the excoriating Sorensen’s article to the board as a class action plaintiffs’ scheme aimed at weakening the company.³¹ The audit committee met and discharged the article’s accusations.³² However the press coverage ignited public investigations. The United States Attorney’s Office for the Eastern District of New York, the grand jury sitting in the Eastern District of New York with the assistance of the FBI, and the SEC started to dig into CA’s business and accounting matters. The board

²⁸ Software companies – the story went – usually offer clients software for a large initial fee for the first-year use, followed by annual fees granting use it, upgrades and technical support. Customers can also enter into a long-term contract, spreading both the initial fee and the annual fees over the term of the contract. If annual fees are considered maintenance fees, they must be booked over time; by contrast, if they are considered license fees the company can book them immediately as instant revenues. According to these former employers, Computer Associates was interested in the contracts that were in the book of each new target company. After the acquisition, salespeople were send to convince customers to extend the existing agreements and the company could re-classify the former maintenance fees of the target as license fees and therefore instant revenues. The figure in Computer Associates’ financial statements offered evidence of this policy, since maintenance fees were declining along the years and were not rising along with license fees. This trend put the company in a different line in comparison to its competitors. The industry standard was for maintenance fees to be around 25% of the overall revenue; they made 14% of the software giant’s revenue in 2000. See Ales Sorensen, A Software Company Runs Out of Tricks, supra nt. __.

²⁹ As Sorensen wrote in a following article “under the new accounting method, the company is rebooking revenue and profit that it has already recognized once under standard accounting rules”: Id., More Than One Way of Looking at Software Maker’s Earnings, N.Y. Times, May 23, 2001, Sect. C, Col. 1, p. 7.

³⁰ Alex Sorensen, A Software Company Runs Out of Tricks, supra nt. __; Id., More Than One Way of Looking at Software Maker’s Earnings, supra nt. __, commenting as follows: “For investors to make a true comparison of Computer Associates’ new sales last quarter with the 2000 quarter, the company would have to disclose how much the $1.3 billion in the new contracts would be worth under standard accounting rules. Computer Associates has declined to make that comparison.”


³² Id., p. 175-177.
instructed the law firm Wachtell, Lipton, Rosen & Katz LLP (WLRK) to represent the company and cooperate with the investigations, and PwC to conduct a study (not a forensic audit) of the two fiscal quarters immediately preceding the vesting of the KESOP shares. The results of these activities convinced the board members that the N.Y. Times article as well as the following criminal investigation were fed by class action lawyers and disgruntled employees and were not to be taken seriously. In the middle of the investigations, on November 18, 2002, the founder and chairman of the company, Charles Wang, resigned, leaving the leadership in the hands of his pupil, Kumar. CA pointed out that Wang’s decision was not connected to the investigation.

For two years the top executives denied to the company’s lawyers and the investigators that they had committed any illicit practice. The investigators, who relied on CA’s customers documentation of deals and employees’ declarations, expressed their extreme disappointment about CA’s efforts to establish the truth. In order to ease the pressure on the company, in July 2003 the board asked the audit committee to commence its own internal investigation. The audit committee instructed its own law firm, Sullivan & Cromwell, which started a new round of interviews and documents analysis. On August 8, 2003 the firm agreed to settle all pending civil litigation. The global settlement was approved by the federal court on December 2003. It released CA’s directors, officers and (limited to the class action’s release) employees.

In the meantime the truth (or part of it) was slowly coming to the surface. On October 8, 2003 the software company had already issued a press release, pointing out that its audit committee’s investigation had ascertained that revenue were recognized

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prematurely in the fiscal year ending March 31, 2000. On January 12, 2004, CA disclosed that the SEC had sent a Wells notice. In the following months some top executives pleaded guilty of obstruction of justice and agreed to cooperate with prosecutors. On April 26, 2004, the Audit Committee’s released its final report, declaring that the company had improperly recognized $2.2 billion in revenue for fiscal years 2000 and 2001. The board removed the apparently unassailable Kumar as CEO, Chairman, and President of CA. On September 22, 2004, Kumar and another top executive were indicted on charges of securities fraud, perjury, and obstruction of justice. On September 22, 2004, the Company acknowledged that, through the conduct of its executives, it had violated the law. CA entered into a deferred prosecution agreement with the USAO, accepting responsibility. In response to this new information, a new series of derivative actions erupted against former CA’s executives. A special litigation committee was established in February 2005. At this time it was already clear that

“The claims … arise out of a massive accounting fraud perpetrated by the Company’s senior-most executives from as far back as the late 1980s through 2001, and their cover-up of that fraud, which lasted through mid-2004. That conduct – the practice of extending CA’s fiscal quarters beyond their natural conclusion to prematurely recognize additional revenue – has come to be known as, and will be referred to as, “the 35-Day Month.”

The 35-Day Month fraud permitted the company to meet analysts’ projections. However, no evidence of double-booking was gathered during the investigations. As one commentator has noted, “if the above practice was consistently followed, as alleged, what one had at the end of the day was one quarter with an extra five days and, thereafter, three quarters of the usual length defined in nontraditional, and undisclosed, terms (i.e., starting

35 A Sorensen, Computer Associates May Face S.E.C. Action, N.Y. Times, January 13, 2004, Section C; Column 5; Business/Financial Desk; Pg. 1
36 SLC Report, at 1.
five days into the usual start of the quarter and ending five days after the normal ending
date).”

Nevertheless, in 1998 the fraud inflated the stock price during the period it traded
above the threshold required by the KESOP for the accelerated vesting. For this reason
also, on April 13, 2007, the special litigation committee advised that it was in the best
interest of the company to pursue its civil claims against Wang, CA’s founder, the only
executive still untouched (claims against Kumar and Artzt were already settled). On
August 14, 2007, Kumar, Wang’s protégé, who had pleaded guilty on April 24, 2006,
started his twelve years sentence. Meanwhile CA has survived the storm. Today the
company is still a world leader in its market. The accounting was faulted but the business
model was sound.

The special litigation committee has tried to explain what went wrong at CA. The
company was still managed in the 1990s as a start-up venture run by his founder, with no
appropriate control processes and managerial procedures, in a culture of fear that did not
offer room for any form of dissent and in which “missing Wall Street estimates was to be
avoided at all costs.” The company was lacking any reporting structure, with
information and control in the hands of a few top executives. CA employed “what was
essentially a homegrown hodge-podge of accounting and financial reporting systems.”
The work force, from top to bottom, “was unable to recognize the wrongfulness of its

38 SLC Report, at 5
39 At p. 7.
own conduct.”40 The conclusions reached by the special litigation committee with regards to the toxic atmosphere that reigned in CA are straightforward:

“In the end, the fraud at CA was directed by a group of CA’s most senior managers who acted intentionally to violate the accounting rules and then covered it up. However, the fraud pervaded the entire CA organization at every level, and was embedded in CA’s culture, as instilled by Mr. Wang, almost from the Company’s inception. Indeed, the improper practices became CA’s standard practices to the point that the fraud was ‘hidden in plain sight’ and became part of CA’s normal day-to-day business. CA’s failure to have an organizational structure, policies, and practices consistent with that of a multi-billion dollar market-cap, publicly-traded company contributed substantially to promoting an environment which allowed the fraud to begin and to continue at the levels it did for as long as it did.”41

**Enron**

Enron, the poster-child for corporate fraud and abuse, began as a sleepy gas pipeline company. Its corporate predecessors included InterNorth, a natural gas company headquartered in Omaha, Nebraska and the Houston Natural Gas Company of Houston, Texas. The merger of these two resulted in the formation of Enron Corporation in 1985.

After 1985 Enron grew and diversified at a dizzying pace. It expanded its gas pipeline distribution network and then morphed away from its prior identity. In 1997, the natural gas pipeline business accounted for approximately half of Enron’s revenues.42 Three years later, pipelines would represent only about 20% of Enron’s revenues.43 The change was not due to a reduction in its pipeline activities, but rather to massive growth by Enron in other businesses,44 most notably wholesale energy business and online

40 At 7.
41 At 9.
trading system, as well as metals trading, risk management services, water supply, wind power generation, paper and pulp trading, and other initiatives. By 2001 Enron was the seventh largest company in the United States.

Enron’s phenomenal expansion was facilitated by easy access to capital. Its platform of gas pipelines generated large amounts of free cash flow, which allowed Lay to provide partial internal financing for his grandiose schemes and to generate the appearance of a firm poised on the brink of greatness. Later, the company took advantage of the high-tech bubble of 1997-2001. The core business of Enron was not high-tech. But Enron’s sophisticated approach to its business, its heavy use of financial derivatives, and its corporate dynamism all reflected the corporate ethos of the high-tech boom. Enron jumped at the chance to enter this new market. Enron established itself as a leader in the development of a wholesale market for bandwidths, and was the first energy company to open an e-commerce portal, Enron Online. During the dot.com boom, Enron’s broadband assets were a significant aspect of its market value.

The rise and fall of Enron is inextricably intertwined with the personality of its founder, Kenneth Lay. Even in the early 1980s, when was still serving as chairman of the Houston Natural Gas Corp., Lay was a man in a hurry. With six months of

46 See Margaret Boitano, Is Dynegy The Next Enron? Probably not. It's more like the anti-Enron. But guess which of the two energy stocks is growing faster. (Hint: The company's name is a play on the word "synergy."), Fortune Magazine, December 18, 2000, available at 2000 WL 24218743.
47 See Margaret Boitano, Is Dynegy The Next Enron? Probably not. It's more like the anti-Enron. But guess which of the two energy stocks is growing faster. (Hint: The company's name is a play on the word "synergy."), Fortune Magazine, December 18, 2000, available at 2000 WL 24218743.
48 See Matt Moffett, Lay Doubles Houston Natural Gas's Size In Only 6 Months as Chairman and Chief, Wall Street Journal, December 4, 1984, available at 1984 WL-WSJ 200232 (reporting that in only six
assuming control he doubled the size of his company, and within two years, he pulled off
the merger with InterNorth and assumed control over the combined corporation. Lay was
now head of the nation’s second-largest natural gas pipeline system and the first truly
nationwide system in the country. 49

Lay’s vision went far beyond natural gas distribution. He envisaged Enron as a
world leader in many related fields. And he had the energy and dynamism to bring this
plan to reality – or so it seemed. Lay’s management style was hard-charging and
competitive, displaying a nearly insatiable taste for risk and innovation. 50 His attitude
was bullish, predicting ever better times ahead for his company. 51 He was widely
credited with a pioneering approach to the development of interstate gas pipeline
networks, 52 and later, as head of Enron, was touted as a “visionary.” 53 As his optimistic
predictions appeared to be confirmed, Lay gained a cult-like following. He appeared
nearly super-human, a mastermind whose achievements could only inspire amazement. 54
Lay imposed his personal stamp on Enron, but did not monopolize control over the firm. Instead, he shared managerial responsibility and left many key operating decisions to a small group of trusted subordinates, including Jeffrey Skilling, the President and Chief Operating Officer, and Andrew Fastow, the Executive Vice President and Chief Financial Officer. Persons outside this charmed circle, however, appear to have exercised little or no real authority.

During its heyday Enron enjoyed a reputation for dynamism and innovation virtually unmatched in American industry. It was a reputation which the company valued and burnished at every opportunity. Like other firms in our sample, Enron associated itself with a prominent athletic team, in this case the Houston Astros. Enron purchased the naming rights to the team’s baseball stadium and dubbed it “Enron Field.” The company generated a sense of movement and dynamism, in part by rotating staff from position to position with dizzying frequency.55 Enron won Fortune Magazine’s “Most Innovative Company in America” award for five years running, and – in what may now seem something of a grim joke – took first place in 2000 for “Quality of Management” and second place for “Employee Talent.”56 Financial Times Energy awarded Enron the prize in 200 for the “Boldest Successful Investment Decision” for spending $100 million nodded dumbly. Others shouted out half-baked questions. Having expanded Enron's market capitalization ninefold over the past decade, asked one boss, could he possibly top that? "We'll do it again this coming decade," he responded coolly. Mouths fell agape.

for the creation of EnronOnline.\textsuperscript{57} An article in Fortune Magazine referred to it as an “awe-inspiring juggernaut.”\textsuperscript{58}

Enron too exercised political connections to the fullest. Kenneth Lay was one of the top fifty individual donors of soft money among a survey of business executives in 2000, with $361,000 in contributions.\textsuperscript{59} In 1992 Lay served as co-chairman of President George H.W. Bush’s re-election committee and chairman of the Republican National Convention, which took place in Houston that year. Lay was also a major contributor to George W. Bush’s campaigns, and was known to the latter by the moniker “Kenny Boy.” Lay was at one time a candidate for Secretary of the Treasury in Bush’s administration.\textsuperscript{60} Although Enron was widely associated with Republican causes, it spread its largesse in a true spirit of bipartisanship. At the Democratic National Convention in 2000, Enron sponsored a lunch honoring Sen. Bob Kerrey of Nebraska a breakfast for the California delegation and events for Texas and New Mexico Democrats.\textsuperscript{61} In addition to making campaign contributions, Enron was also savvy at hiring politically connected individuals. Enron and its affiliates hired former Secretary of State James Baker and former Commerce Secretary Robert Mosbacher, both of whom had served in the administration of George Bush, Sr.\textsuperscript{62}

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\item[58] See Margaret Boitano, Is Dynegy The Next Enron? Probably not. It’s more like the anti-Enron. But guess which of the two energy stocks is growing faster. (Hint: The company's name is a play on the word “synergy.”), Fortune Magazine, December 18, 2000, available at 2000 WL 24218743.
\item[60] See Campaign Donors Take Seats at Presidential Advisory Table, Augusta Chronicle, December 31, 2000, available at 2000 WL 31511548.
\item[61] See Jake Thompson and C. David Kotok, Big Business Parties With Democrats Delegates, Politicians Treated to Fine Dining, Omaha World-Herald, August 17, 2000, available at 2000 WL 4371032.
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Enron’s larger-than-life approach to management applied to its internal spending habits as well. Its Christmas parties, some held at Enron Field, were known as sumptuous affairs. Even in 2001, as the firm headed for bankruptcy, it planned for a $1.5 million Christmas bash. Secretaries were rewarded with gifts of spa visits and Waterford Crystal on Secretaries’ Day. No gesture seemed too lavish or extravagant. For a firm picnic, the firm rented the 85-acre Astroworld amusement park. One division was in the habit of bringing a live elephant to enliven employee meetings. When Enron’s shares rose over $50 in 1998, the company left $100 bills at each employee’s desk. At Enron’s London headquarters, a sumptuous building in one of the city’s toniest neighborhoods was equipped with $30 million worth of decorations and fixtures.

These gestures were matched by more substantive actions: Enron paid salaries at or above the top of its market, and provided desirable perks to employees such as first class travel, generous expense accounts, and the like. The company flew in more than 300 of its vice presidents from around the globe to a luxury resort in Beaver Creek, Colorado for three days of skiing. With swollen paychecks, Enron managers were famous in Houston for purchasing expensive cars and building mansions in the town’s best neighborhoods.

Enron’s was a darling among securities analysts, who viewed it as an exciting new player in the corporate arena. Enron was careful to encourage favorable analyst reports. It assiduously catered to them and reportedly spent hundreds of thousands of dollars to build a mock trading floor, solely in order to impress equity analysts at a conference.63 With the favorable buzz of analysts’ reports and the adulation of the financial press, it

was not surprising that Enron’s share price would display a meteoric rise, in the process enriching not only Lay and other senior managers, but many ordinary employees of Enron as well who owned the company’s shares in their retirement portfolios. The company’s stock peaked at $90/share in early August 2001.

Despite all this apparent success, Enron presented something of a puzzle to anyone who would look objectively at its performance. Aside from the gas pipeline business, which generated solid and reliable profits, the other ventures never fully proved themselves beyond the extravagant hopes that attended their creation. It was, moreover, exceedingly difficult to figure out how Enron was actually structured, or how its financing operations worked in any level of detail. At Enron, the needless complexity took the form of extremely convoluted deals with ostensibly independent partnerships. At the time of its collapse, Enron reportedly had more than 3,000 off balance sheet subsidiaries and partnerships. In point of fact, as it was later discovered, Enron experienced poor operating performance. Its core business of making merchant investments had experienced very large losses that the management wished to conceal by creating the illusion that the losses had been hedged by contracts with independent parties which were obligated to assume the incidence of loss.

Many of the off-balance sheet deals that Enron used to bamboozle the market were later shown to be fraudulent. The special purpose entities with which it dealt turned out not to be independent at all. In some cases Enron essentially funded the entities to which it was selling its own assets. In many cases the market value of the assets Enron

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64 See Witness Statement of Professor Frank Partnoy, hearings before the United States Senate Committee on Governmental Affairs, January 24, 2002, available at 2002 WL 2010093.
was selling was grossly inflated. Many of these structured finance deals occurred at the end of the quarter or fiscal year, fueling suspicion that they were being orchestrated for purposes of massaging the balance sheet rather than for genuine financing reasons.

Enron’s collapse, when it came, was swift and unforgiving. In early August 2001 one analyst, Daniel Scotto, broke ranks and advised investors to bail out of the company as quickly as possible. Things deteriorated rapidly thereafter. On August 17 Skilling, in a disastrous analyst conference call, cursed out prominent analyst Jack Grubman for questioning the company’s financials. Things only worsened after it was disclosed that Enron had lost millions of dollars as a result of non-arms length investments in partnerships controlled by Fastow – investments that had earned millions of dollars for Fastow. The company’s stock tanked as rumors of fraud circulated in the market, leading quickly to Enron’s bankruptcy filing in the beginning of December 2001.

The aftermath of the Enron debacle was bloody. Arthur Anderson was prosecuted and found guilty of obstruction of justice for shredding documents related to its external audits of Enron, and in consequence was forced out of business. Congress, in response primarily but not exclusively to the Enron scandal, enacted the Sarbanes Oxley Act, legislation which significantly tightens corporate governance standards for publically traded American companies. Civil fraud suits were commenced against nearly everyone involved in Enron’s financial reporting, including its officers, its banks, its auditor, its outside counsel, and others; the litigation has been one of the most complex and contentious in American history. Skilling was sentenced to a 24 year term in 2006 and is

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66 Fastow alone received more than $30 million from Enron, his subordinate Kopper by at least $10 million, and several others by one million or more. Powers Report 4. As the Powers Report concluded, these partnerships were used by Enron’s management to “enter into transactions that it could not, or would not, do with unrelated commercial entities.” Id. at 3.
presently serving time in federal prison in Waseca, Minnesota. Lay was also convicted of multiple felonies but died before a sentence could be imposed. Fastow pleaded guilty and was sentenced to six years in exchange for his cooperation in the cases against Skilling and Lay; his wife, who had served as an assistant treasurer at Enron, was also sentenced to a one-year term in prison. And Enron Field, the most prominent public symbol of the company’s rise to glory, has been renamed “Minute Maid Park.”

**Global Crossing**

Global Crossing’s fate is intimately tied in with the telecom bubble that generated enormous run-ups in profits and share prices for telecom companies at the end of the last century and that finally burst in 2001 and 2002. Gary Winnick, an investor who had begun his career working with junk-bond king Michael Milken, founded the company in 1997 and served as the company’s chairman until 2002. The company’s business was dealing in fiber-optic capacity, which was in increasing demand as telecom firms such as AT&T rapidly expended their demand for bandwidth.

Global Crossing expanded at warp speed during its brief but spectacular florescence. In 1999, the year of its greatest growth, the company consummated major acquisitions including Frontier Corp. ($11.2 billion) and Global Marine ($850 million) – thereby transforming itself into a major player in the telecom industry. At its peak the company had more than 14,000 employees. At the same time as this expansion program was underway, Global Crossing’s stock price was soaring, rising from around $40/share at the beginning of 1999 to over $120/share only five months later. At the peak the company’s market capitalization was $54.5 billion even though the company had never
turned a profit. Global Crossing’s spectacular growth and share price increase greatly enriched its founder. Winnick rapidly catapulted into the ranks of America’s business elite; a Forbes cover feature on his rise was titled “Getting Rich at the Speed of Light.”

Winnick was a dominating figure at the company throughout its short but spectacular history. He founded the company and remained its Chairman until its failure. Winnick He owned 8.9% of Global Crossing’s stock in 2001, and the investment company which he headed, Pacific Capital Group, held approximately 1% more. Pacific Capital also owned and co-occupied the company’s Beverly Hills offices. Winnick reportedly demanded obeisance from employees, once firing a temporary worker for not recognizing him in an elevator and running through five chief executive officers in less than five years. Winnick’s control over Global Crossing was mitigated, however, by the fact that he did not serve as CEO during the period of the alleged frauds – a fact which may have helped save him from the threat of prosecution once the problems at the company came to light.

Global Crossing eagerly sought favorable publicity during its glory days. Like several other firms in our sample, it associated itself with high-profile sports – a NASCAR racing sponsorship. Global Crossing was also exceptionally active in seeking political influence through campaign contributions, with campaign contributions exceeding even those of Enron. According to the Los Angeles Times, the company pressured its senior employees to make extensive contributions totaling $2.8 million in

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68 Jim Hopkins & Matt Krantz, Global’s warning signs there, Wall St. was unaware, USA Today, February 26, 2002.
69 Jim Hopkins & Matt Krantz, Global’s warning signs there, Wall St. was unaware, USA Today, February 26, 2002.
1999-2000, placing the company 23rd on the list of top donors to national political parties, candidates for federal offices and political action committees. By 2000, Winnick had personally contributed more than $300,000 to political campaigns. George Bush, Bill Clinton, former Secretary of State Madeleine Albright and California Governor Gray Davis all reportedly attended Global Crossing events and dinners honoring Winnick. Winnick brought former California Governor Pete Wilson onto the board of his investment firm, Pacific Capital Group. Terry McAuliffe, head of the Democratic National Committee, reportedly made a profit of nearly $18 million on a $100,000 investment in the company. Jim Hopkins & Matt Krantz, Global's warning signs there, Wall St. was unaware, USA Today, February 26, 2002.

Global Crossing was noted for extravagant spending, especially for lavish compensation packages for its executives. Global Crossing’s insiders received many millions in dollars of personal loans from the company as well as lucrative signing bonuses and stock option plans. Insiders, especially Winnick, were also criticized for enriching themselves by selling Global Crossing stock at a time when the share price was inflated. The company’s headquarters in Beverly Hills, California were equally lavish, costing a reported $41.5 million to purchase and $9 million to renovate. Winnick’s office reportedly had a million dollars worth of furniture and a $15 million Picasso hanging outside the door. The company was criticized for reckless spending on items such as

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70 Elizabeth Douglass & Karen Kaplan, Global Pressured Employees to Make Campaign Donations, Los Angeles Times, April 14, 2002.
71 Elizabeth Douglass & Karen Kaplan, Global Pressured Employees to Make Campaign Donations, Los Angeles Times, April 14, 2002.
72 Elizabeth Douglass & Karen Kaplan, Global Pressured Employees to Make Campaign Donations, Los Angeles Times, April 14, 2002.
74 Jim Hopkins & Matt Krantz, Global’s warning signs there, Wall St. was unaware, USA Today, February 26, 2002.
seven corporate jets, $150 million in accounting software that was never used. Winnick was no less generous with his personal expenditures: he occupied the most expensive house in the United States and traveled in a $12.5 million jet. Winnick and his wife were major donors to Jewish and other charities, including $40 million for a branch of the Simon Wiesenthal Center in Jerusalem, and as much as $100 million for a host of charities such as the Los Angeles Zoo and the Los Angeles Public Library.

The securities fraud at Global Crossing allegedly commenced in 2000, when the dotcom bubble burst, and accelerated in 2001 as telecoms followed suit. Global Crossing began to lose customers, and to rely for profits on swaps of broadband capacity, which had become nearly useless. The sole purpose of these swaps, according to complaints filed against the company, its officers, and others, was to disguise the company’s worsening financial position by creating fictitious profits at the close of each fiscal quarter. The complaints alleged that the swaps were nothing else than sham transactions without economic substance. Notwithstanding these alleged efforts to shore up the company’s financial reporting, Global Crossing’s share price experienced a precipitous decline, accelerating in 2001 and 2002. The company declared bankruptcy early in 2002. Winnick resigned soon after. Asian investors rescued the company later that year.

It was inevitable that legal proceedings would ensue. The Department of Justice considered bringing criminal charges, but decided late in 2002 not to proceed. The SEC also launched a probe of Winnick and others. After three years of investigation the commission staff reportedly recommended that charges be filed but were overruled by the

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75 Elizabeth Douglass & Karen Kaplan, Global Pressured Employees to Make Campaign Donations, Los Angeles Times, April 14, 2002.
Commission, which decided not to pursue the matter.\textsuperscript{77} There thus has been no official determination that anyone at Global Crossing committed actionable offenses.

Global Crossing, Winnick, and others were less successful in other cases, however. The Department of Labor brokered a $79 million settlement between Global Crossing Executives and former employees whose pensions were wiped out – including $25 million from Winnick.\textsuperscript{78} Private securities fraud litigation resulted in settlements totaling more than $448 million, including approximately $245 from Winnick and Simpson Thatcher & Bartlett, Global Crossing’s former outside counsel. Despite these setbacks, Winnick remains active in the investment world, serves on several charitable boards, and produces Broadway musicals.

\textit{Health South}

Richard Scrushy and a few associates founded HealthSouth in Birmingham, Alabama in 1994. The business plan called for the development of private outpatient facilities in order to take advantage of changes in the Medicare law enacted in 1980 which authorized Medicare reimbursement for outpatient rehabilitation facilities. It started its corporate life as a small private company, but rapidly expanded as the market for outpatient services grew. HealthSouth went public in 1997 and was listed on the New York Stock Exchange in 1998. HealthSouth thereafter continued its rapid expansion, diversifying into related fields such as sports medicine and workers compensation services. It eventually became the first private outpatient service provider doing business in all fifty states. By 2001 HealthSouth was the world’s largest outpatient surgery

\textsuperscript{77} See David Colker & Chris Gaither, Founder Escapes Charges in Global Crossing Failure, Los Angeles Times, December 14, 2004.

\textsuperscript{78} See David Colker & Chris Gaither, Founder Escapes Charges in Global Crossing Failure, Los Angeles Times, December 14, 2004.
company, rehabilitation and diagnostic services company with over 48,000 employees and more than 17,000 facilities across the country. Its stock had performed brilliantly, hitting a high of over $15.00 in May 2001.

Scrushy profited handsomely from HealthSouth during its boom years. According the federal indictment, he received approximately $267 million from the company between 1996 and 2002—which this did not include huge gains on his stock portfolio. He did not stint on spending some of these riches on himself or his family. He and his wife reportedly owned two airplanes, dozens of automobiles, nine boats, several million dollars of jewelry and properties valued at more than $22 million.

Scrushy had a strong appetite for publicity and an intuitive understanding of what would sell his product. HealthSouth sponsored a traveling road show using prominent athletes and performers to promote a healthy lifestyle to as many as 50,000 children and teenagers a week. A relentless self-promoter, Scrushy had one commentator noted, a “penchant for building monuments to himself that appeared with a frequency usually reserved in Alabama for dead football coaches and Civil War heroes.” He caused a life-sized statute of himself installed in the HealthSouth Medical Center. His band, Dallas County Line, cut a CD and toured Australia. He also co-hosted a radio program with local radio show with Jason Hervey, a former child actor who played Wayne Arnold on The Wonder Years and who Scrushy hired as head of communications for HealthSouth.

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80 See Greg Farrell, Former HealthSouth CEO Scrushy turns televangelist, USA Today, October 25, 2004.
82 Bill Hallman, Pushing His Luck, 14 Corporate Counsel 88 (March 2007).
Like other CEOs in our sample, Scrushy was a generous giver to charitable causes. As his website describes it, “his circle of giving has a vast diameter.” He and his wife purchased a bottle of wine at a celebrity auction in 2001 for $33,000. He made many gifts to schools in the Birmingham area, insisting that the building or library be named after him. After the firm ran into trouble, he became a generous donor to churches in Birmingham and set himself up as a fundamentalist lay minister and televangelist in the Birmingham, Alabama area. He and his wife Leslie now operate a ministry which also, on its web site, proclaims him innocent of wrongdoing in the HealthSouth fraud.

Scrushy was also a generous, but not lavish contributor to political campaigns. His company, however, reportedly channeled hundreds of thousands of dollars into state political campaigns. And Scrushy apparently knew how to distribute funds to politicians in other ways. In 1999, he allegedly arranged for a $500,000 bribe to be paid to Don Siegelman, the then-governor of Alabama, in exchange for a seat on the board that regulates the state’s hospitals. Scrushy had a great deal of influence in his home state, as illustrated by his apparent orchestration of special legislation exempting HealthSouth’s proposed digital hospital from the state’s certificate-of-need law.

Scrushy and his wife hosted a dinner for former President George Herbert Walker Bush

86 http://www.richardmscrushy.com/biography.aspx
89 Bill Hallman, Pushing His Luck, 14 Corporate Counsel 88 (March 2007).
90 See http://www.morningviewpoint.com/
91 See http://www.scrushy-ministries.com/
92 See Michael Romano, Exception to the CON rule; HealthSouth's exemption from certificate-of-need law draws Alabama Hospital Association into legal fray, Modern Healthcare, October 14, 2002.
93 See
94 See Michael Romano, Exception to the CON rule; HealthSouth's exemption from certificate-of-need law draws Alabama Hospital Association into legal fray, Modern Healthcare, October 14, 2002.
and 1,600 friends at the Richard Scrushy Conference Center in October 2001. After his legal troubles started in earnest in 2003 and his subsequent indictment on federal fraud charges in Birmingham, Scrushy cultivated the favor of Richard Arrington, Birmingham’s former mayor and a popular figure in Birmingham’s African-American community.

Scrushy was the dominating figure at HealthSouth, serving as both CEO and Chairman and apparently dictating all key decisions. His motivational speeches to his staff were legendary. His own website describes his role at HealthSouth as follows: “Richard Scrushy was clearly the visionary who created HealthSouth from the ground up, listing the company on the New York Stock Exchange, consolidating the industry into an efficient operation, aligning the company with excellent physicians across the country, and overseeing approximately $6.5 billion in strategic acquisitions.”

Published reports suggest that regardless of HealthSouth’s formal governance structure, Scrushy’s word was the effective law of the firm. According to the SEC’s complaint, for example, Scrushy simply refused to accept financial reports that fell short of analyst expectations, instead directing the accounting personnel to “fix it.”

HealthSouth appears to have been founded on a sound business model and to have been reasonably managed with respect to its underlying operations. But the company also was harboring a dark secret: much of its outstanding record of profitability was

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96 See Bill Hallman, Pushing His Luck, 14 Corporate Counsel 88 (March 2007).
98 See http://www.richardmscrushy.com/biography.aspx
based on a continuing pattern of fraud, resulting, before the misconduct came to light, in billions of dollars in overstated profits.

The fraudulent practices at HealthSouth were longstanding, commencing soon after the company went public in 1986, according the SEC.\textsuperscript{100} The strategy of the fraud was straightforward. HealthSouth simply inflated its income each year of the fraud and accounted for the inflated profits by increasing stated assets. Over time, however, as the fraud continued, it became increasingly difficult to sustain the fiction. According to the SEC, the company’s statement of earnings before taxes and interest on the 2001 Form 10K was inflated by at least 4,700\%.\textsuperscript{101}

The scheme began to unravel in 2002, when newspapers reported that Scrushy may have improperly sold HealthSouth stock based on inside information that the federal Medicare agency had changed its rules on physical rehabilitation reimbursements.\textsuperscript{102} The insider trading allegations triggered investigations and focused unwelcome attention on the firm and its operations. The accounting fraud came to light in March 2003. On March 19 the SEC charged HealthSouth and Scrushy with conducting a massive fraud. The FBI raided the company’s headquarters. Scrushy was placed on a leave of absence and fired a few weeks later. HealthSouth defaulted on its debt and was threatened with bankruptcy, but managed to obtain forbearance from its lenders and survived. The company’s stock tanked, trading as low as 15 cents per share in 2005.

Massive civil and criminal litigation followed the disclosures at HealthSouth. The company H agreed to a $445 million settlement with shareholders and a $100 million

\textsuperscript{100} Complaint, SEC v. HealthSouth Corporation, No. CV-03-J-0615-S, Northern District of Alabama.
\textsuperscript{101} Complaint, SEC v. HealthSouth Corporation, No. CV-03-J-0615-S, Northern District of Alabama.
\textsuperscript{102} Statement of Lanny Davis before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, November 5, 2003.
settlement with the SEC. The Justice Department obtained an indictment against Scrushy and other HealthSouth officers, charging them with masterminding a massive and continuing fraud. Fifteen employees of HealthSouth staff pleaded guilty to participating in the fraud, including five former chief financial officers. Scrushy took his chances with a trial and was acquitted in 2005. He was, however, convicted in 2006 in a separate trial of bribing the Governor of Alabama and sentenced to 82 months in prison. Scrushy appealed his conviction but was incarcerated in June 2008 when his request for release on bond pending appeal was denied.

**Lernout & Hauspie**

Lernout & Hauspie Speech Products NV was a Belgian corporation with executive offices in Burlington, Massachusetts. L&H developed and licensed speech technologies, including speech recognition software. Jo Lernout and Pol Hauspie founded it in 1987. In late 1995, the company went public on NASDAQ.

The company went through a massive and rapid growth, which was propelled by fraudulent schemes and by over 20 corporate acquisitions. Acquisitions intensified in 2000, when L&H exploited the exceptionally high valuation of its stock, with prices at their all time high. On March 7, L&H announced the acquisition of Dictaphone in a stock

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104 L&H described itself as ‘a global leader in advanced speech and language solutions for computers, automobiles, telecommunications, embedded products, consumer goods and the Internet. The company is making the speech user interface (SUI) the keystone of simple, convenient interaction between humans and technology to break down cultural barriers. L&H’s products and services originate in four basic areas: automatic speech recognition (ASR), text-to-speech (TTS), digital speech and music compression (SMC) and text-to-text (translation)’: see PR Newswire, November 2, 1998, quoting L&H’s press release of November 1, 1998, concerning a strategic partnership with AsiaWorks.
105 Mr. Lernout was a sales executive with the Belgian arm of Wang Laboratories, while Mr. Hauspie owned a small firm that made accounting software: see M. Maremont, J. Eisinger and J. Carreyrou, ‘How High-Tech Dream Shattered in Scandal at Lernout & Hauspie’, WSJ, December 7, 2000, who add: ‘The company barely survived several early financial crises’.
and debt deal worth about $935 million that would have roughly doubled the company’s revenues and increased its debts by $425 million.106 A few weeks later, L&H announced another large acquisition concerning Dragon, which was bought for around $445,2 million by issuing new shares.107 Both acquisitions were made by L&H almost on the verge of its bankruptcy.

L&H reported increasing revenues, although not profits, over much of its corporate existence. In 1995, the year it became a public company, L&H reported a net loss of $14 million with total revenues of only $7.7 million. In 1996, L&H’s revenues climbed to $31 million and, in 1997, to $99.4 million, with reported losses of $7.9 and 13.3 respectively. Revenues were boosted by acquisitions and by sales to a web of customers with which L&H had financial ties.108 Indeed, when L&H went public, its founders Lernout and Hauspie contributed to create a venture capital fund, the Flanders Language Valley Fund NV, with the help of some L&H’s supporters, like Microsoft and the government of Flanders.109 L&H referred potential customers in need of cash to the FLV Fund, with the result of increasing its sales power. This raised suspicions with analysts and convinced some investors to dump their shares in L&H, as it was not clear whether the relevant sales of software would have occurred without the “polygamous relationship” at issue.110

107 See Dow Jones International News, March 28, 2000, defining the deal as too dilutive for L&H.
108 Id., defining the same as ‘related parties revenues’.
109 Id., specifying that until 1997 Messrs. Lernout and Hauspie were directors of the FLV Fund’s investment arm, mainting afterwards considerable influence over its affairs.
Another mechanism to inflate revenues was to have outside investors funding a start-up company, which would then contract with L&H to develop software. As alleged by the SEC in a complaint filed in 2002: “Between 1996 and 1999, L&H improperly recorded over $60 million in revenue from transactions with two Belgian entities – Dictation Consortium N.V. (‘Dictation’) and Brussels Translation Group N.V. (‘BTG’) - formed for the purpose of engaging in transactions with L&H. Transactions between L&H and these two companies were arranged to allow L&H to fraudulently claim revenue from its own research and development activities ….”111 L&H subsequently acquired both companies on terms that repaid the amounts they had previously paid to L&H, plus a substantial profit: “Because the transactions … were disguised loans and not sales or service contracts, L&H should not have recognized revenue from those transactions under General Accepted Accounting Principles (“GAAP”).”112

In another case of late 1998, thirty companies were set up as ‘strategic partners’ to develop L&H’s software for specific applications and languages. As later alleged by class action plaintiffs, the partners paid licensing fees to L&H, which recorded the same as revenue, despite the fact that most of the companies “were owned by parties related to L&H, including FLV Fund and Mercators.”113 Moreover, L&H’s employees performed the development work for their partners, with L&H financing research and development costs. When the software was developed, L&H purchased its strategic partner and

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112 Id., para. 12.
113 See In re Lernout & Hauspie Securities Litigation, United States District Court for the District of Massachusetts, 208 F. Supp. 2d 74, 80 f.
capitalized most of the purchase price as “goodwill”, including the amounts spent on research and development. As the plaintiffs alleged, by doing so L&H prevented the bulk of its research expenditures in the areas at issue from appearing on its earning statements.\textsuperscript{114}

As a result of these strategies and acquisitions, L&H’s total reported revenue rocketed to $211.6 million in 1998, $344.2 in 1999 and $463.1 in 2000. However, this success story began to unravel in July 2000,\textsuperscript{115} after the acquisition of Dictaphone Corporation, which transformed L&H into a US company for SEC filing purposes, with the duty to publish a geographic breakdown of its sales.\textsuperscript{116} L&H’s filing for 1999 disclosed that Korea contributed 18.2 per cent of its total revenue and Singapore 23.3 per cent. Analysts were puzzled, as they did not expect such high growth from Korea and Singapore, when revenues from the US, Europe and the rest of Asia were substantially declining.\textsuperscript{117} The Wall Street Journal made its own inquiry, contacting 18 of about 30 companies mentioned by L&H as customers. A few declared that they were not customers, while some other confirmed purchases from L&H, however for smaller amounts than those stated by L&H’s top managers.\textsuperscript{118} This increased suspicions, despite L&H’s vehement reactions and request for a midyear audit by KPMG. In late August,

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\textsuperscript{114} Id., specifying: ‘Plaintiffs allege that L&H derived substantial revenue from these ‘strategic partner’ transactions: 10% of L&H revenues in 1998 and 25% in 1999. As a result of this scheme, L&H improperly booked approximately $79 million in revenue’.

\textsuperscript{115} Id. at 81.

\textsuperscript{116} See M. Maremont and J. Eisinger, ‘Lernout Shares Fall Amid Revenue Disclosure’, WSJ, July 6, 2000, B6 stating that, before the acquisition of Dictaphone, L&H had been filing under less-stringent rules as a foreign company.

\textsuperscript{117} See J. Eisinger, ‘Lernout’s Filing Puts Asian Success in US Context’, WSJ, July 7, 2000, 11, referring to a stock analyst at Lehman Brothers who suspended coverage of L&H, as his firm inquired about Korean sales.

\textsuperscript{118} Id.; see also the article by M. Maremont, J. Eisinger and J. Carreyrou, note 105.
L&H board forced Bastiaens, the CEO, to resign, while the SEC launched a formal investigation of L&H.119

In December 2000, L&H acknowledged the need to restate its financial statements for 1998, 1999 and the first half of 2000. At the same time, information became public through the press about a blatant fraud which had inflated earnings at L&H’s Korean subsidiary.120 As a result, L&H’s stock price fell from a high of $72.50 in March 2000 to $ .73 on December 29, 2000. The company filed a voluntary petition for reorganization under both US law and Belgian law; however, courts determined that reorganization and recovery were not possible, and the company went into liquidation proceedings both in Belgium and the US. Rather than being similar to Microsoft, which had a stake of 8 per cent in its capital, L&H turned out to be a small Enron.121 Its spectacular growth, which brought the company to a market capitalization of nearly $10 billion in 2000, was largely determined by fraudulent transactions and accounting irregularities, the discovery of which almost instantaneously caused the company’s collapse.122

L&H’s communications with the public promoted the image of a powerful company with $1 billion in annual sales, “one poised to follow SAP and Nokia Corp. into

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119 See In re Lernout & Hauspie Securities Litigation, note 113, specifying that news of an SEC investigation became public on September 21, even though an informal investigation by the Commission had begun in January 2000.
121 See, for information on the criminal trial still pending in Belgium, W. Echikson and M. Maremont, ‘Trial in Lernout Scandal Finally Begins. Criminal Case has Enron Similarities; civil suits must wait’, WSJ, May 21, 2007, 7.
122 KPMG’s Belgian and US firms, who were L&H’s auditors, settled the securities law class action against them for $115 million: see the FT, October 2004, 15.
Europe’s tech elite.”

Bastiaens, its CEO, had ‘frequent run-ins with analysts’, which escalated in 2000, when an analyst issued a ‘bombshell report’ claiming that ‘L&H’s growth in the US and Europe was much lower than investors had assumed and that the company was not coming clean’. Bastiaens denied it in a conference call, however refusing to give a geographic breakdown of L&H sales (which he was however forced to publicly disclose later, after Dictaphone’s acquisition).

During the course of its operations the company created complex corporate structures - like Dictation, BTG and the thirty ‘strategic partners’ referred to above – in order to inflate its revenues and conceal R&D expenses. Moreover, controlling shareholders ‘set up an intricate holding-company structure that let the founders retain control while selling various minority interests’. As a result, the founders were entitled to appoint the board’s majority, even if they possessed only 10 per cent of the company’s cash flow rights. In addition, L&H made excessive recourse to related parties transactions, which puzzled investors and analysts. According to a WSJ 1999 article: “the company has tried to increase revenues from other, unrelated customers. Three years ago,

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123 See W. Echikson, ‘How to Spook Investors’, Business Week, September 18, 2000, p. 69, quoting Mr. Bastiaens saying, just a few weeks before being forced to leave his post as CEO: ‘This market is going to explode’.

124 Id., also referring to Bastiaens’s acquisition of 620,000 shares from founder Lernout at a 12.5 per cent premium, at the end of July, which was clearly orchestrated to boost investors’ confidence in L$H and nonetheless puzzled analysts, suspecting ‘a ploy to prop up the stock ahead of bad news’.

125 See notes 111-114 and accompanying text.

126 See M. Maremont, J. Eisinger and J. Carreyrou, note 105, quoting Mr. Lernout admitting: ‘In hindsight … the complexity fed suspicion about the company. To outsiders “it looks like a scam” he says. “But it isn’t”.

127 L&H’s Form 10-K, including its Annual Report for 2000, stated that the company’s board consisted of fourteen members, of which ‘…nine directors elected from candidates nominated thereto by “L&H Holding N.V.”, an entity controlled by Messrs. Jo Lernout and Pol Hauspie, managing directors of the Company as long as entities controlled by Messrs. Jo Lernout and Pol Hauspie (the “L&H Holding Control Group”) hold, directly or indirectly, at least 10% of the outstanding shares of the company ….’.
related-party revenues accounted for 49% of sales. In the first three quarters of 1998, they accounted for only 4%, or $5.4 million, Mr. Bastiaens says. Still, $5.4 million in sales is significant to a company whose net income for the first three quarters of 1998 was $28.6 million.” No doubt, related-party transactions are not illegal and not all L&H’s transactions of this type were hit by allegations of fraud. However, the number and relevance to the company of related-party transactions, together with the complex corporate structures adopted, should have indicated to investors and third parties that L&H’s corporate governance was at least questionable, despite the absence of specific claims concerning the composition and functioning of its board.128

L&H appeared to be dominated by three individuals: its founders, two ‘entrepreneurial celebrities, Belgium’s answer to Bill Gates and Paul Allen of Microsoft’, in the roles of co-chairmen and managing directors; and Gaston Bastiaens, a man with a strong reputation at L&H for having purchased technological leaders and convinced Microsoft to become a shareholder in 1997, in the position of CEO.129 According to the class action complaint, all three directly participated in the alleged fraud together with Nico Willaert, deputy chairman and managing director; all of them are now under criminal trial in Belgium, having been indicted on counts including false accounts, documents forgery and manipulation.130

128 L&H’s board structure, as it appears e.g. from the company’s financial statements for 2000, does not seem to raise specific concerns, also considering that, at the relevant time, corporate governance best practices were not fully developed in Belgium (see, for today’s practices, C. Van Der Elst, ‘The Belgian Struggle for Corporate Governance Improvements’, ECGI Law Working Paper No. 114/2008, available at http://ssrn.com/abstract=1261448).
129 See M. Maremont, J. Eisinger and J. Carreyrou, note 105; see also M. Rose, note 110, stating that the companies’ founders ‘became national heroes of sorts, appearing on magazine covers and sharing podiums with politicians’.
130 See W. Echikson and M. Maremont, note 121, stating that the indictment covers twelve company officials, one outside lawyer, a banker and an accountant. Lernout’s bankers, Dexia, and
Executive compensation looked disproportionate for a company of the size of L&H, particularly with reference to the CEO’s stock options, which were reported for 2000 as exercisable in the amount of $20.5 million, based upon the $23.1 closing stock market price on December 31, 1999 (by March 2000 the stock price would have tripled).\footnote{Id., 77. G. Bastiaens was also indicated as owner of 1,231,000 common shares, i.e. more than he was entitled to buy under the stock options.}

L&H appears to have been politically connected. Politicians, perhaps spurred by national pride, gave their support to L&H, particularly when it ran through early financial crises. The government of Flanders ‘formed a tax-exempt zone in Ieper – grandly known as the Flanders Language Valley – and showered L&H with research grants’; it also became a major L&H investor through its venture capital arm.\footnote{See M. Maremont, J. Eisinger and J. Carreyrou, note 105.} In 1995, the same government, together with L&H and others, created the Flanders Language Valley V.Z.W., a non-for-profit entity, designed to foster the establishment and growth of enterprises seeking to develop and commercialize products based upon advanced speech and language technology.\footnote{See L&H’s Form 10-K for 2000, 64.}

Questions about L&H’s accounting were raised as early as December 1998, when the company revealed that the SEC was reviewing its accounting methods for 12 out of 23 acquisitions it had made since 1996. The problem was that L&H had written off a substantial part of its acquisition costs as ‘purchased research and development’, avoiding the negative impact on earnings it would have faced if it amortized those amounts as

KPMG International, Belgian accounting subsidiary, have been indicted as corporate entities for the same offences.
goodwill over the years.\textsuperscript{134} L&H’s earnings would have been cut in half if all the research
and development write-offs were treated as goodwill, and this had an impact on the
company’s stock price.\textsuperscript{135} On April 4, 1999, L&H announced that it had resolved all SEC
review issues and was restating its financial statements for 1997 and the first 9 months of
1998 in response to comments made by the SEC.\textsuperscript{136}

\textit{Parmalat}

Calisto Tanzi was the heir to a dynasty of food traders based in Collecchio, Parma. At the end of the nineteen sixties Tanzi entered the milk market and Parmalat started its expansion into the dairy industry. During the seventies the Parmalat trademark became popular thanks to high-profile sponsorship of sporting events and sports stars. In the same decade, Parmalat started its penetration of Latin American markets. The 1980s was a period of further expansion and strong political connections. At beginning of the 1990s Parmalat Finanziaria became the listed holding of a group formed by 58 companies, of which 33 based outside Italy, with a group turnover of around ITL 1,100 billion (Euros 560 million). The most significant of these companies was Parmalat S.p.A., the main operating company. After the listing the Parmalat Group (herebelow, “Parmalat”) launched a new international acquisition campaign, which was particularly

\textsuperscript{134} See S.Puliam and M. Rose, ‘Lernout and Hauspie Reviews Accounting’, WSJ Europe, December 4, 1998, 15, specifying that L&H was by no means the only company to use such a strategy. However, L&H was the first small technology company under SEC scrutiny for this accounting method, which could make it more vulnerable to the changes.

\textsuperscript{135} See S.Puliam and M. Rose, note 134. A class action was consequently brought against L&H in the United States District Court for the District of Massachusetts on behalf of all purchasers of L&H securities during the period February 3, 1998, through and including December 1, 1998.

\textsuperscript{136} See J. Stringer, ‘R&D Write-offs Raising Eyebrows of SEC Inspectors’, Mass High Tech, December 21, 1998, No. 51, 1, stating that ‘a problem arises when purchasing companies claim that too much of an acquisition’s price is in the form of inprocess R&D (somewhat around 70 percent to 80 percent is problematic), or ascribes the R&D write-off to activities that the SEC believes do not qualify’.
intense in South America. The group became very active on the capital market, issuing waves of bonds on the Euromarket. The Tanzi’s family also entered the tourism and the football markets in the period.

At the end of the decade the Parmalat Group was still expanding. Between 1998 and 2000 it purchased around 25 companies. The trend continued relentlessly at the beginning of the new millennium. The group was continuously issuing bonds and was therefore a very lucrative client for investment banks. In November 2000 Standard and Poor’s rated Parmalat with a BBB-grade (the lower level of investment grade). Following the problems experienced by Latin American economies (with Argentina’s default in December 2001) and the default of the fellow food manufacturer Cirio in November 2002, Parmalat’s cost of capital increased. Yet the group was still pursuing its apparent strategy of holding a huge amount of cash to be used in mergers and acquisitions whilst financing its cash needs through bonds.138

At the end of 2002 Parmalat Finanziaria S.p.A. was the listed holding of a multinational food group made up of more than 200 companies spread around 50 countries. The group was a world leader in the markets of milk, dairy products and beverages. It operated 139 industrial plants and totalled more than 36,000 employees, with a consolidated turnover of Euros 7.6 billion. Parmalat Finanziaria was controlled by Coloniale S.p.A., the instrument of the Tanzi family that held around 51 per cent of the share capital.141 Parmalat’s 2002 last quarterly report showed Euros 3.35 billion in

137 The problems raised by Argentina’s default in the Italian market are discussed by Consob, Audizione informale sulla diffusione in Italia di obbligazioni pubbliche argentine, 27 April 2004, in www.consob.it
138 See next paragraph.
141 Consob’s website, 30 June 2003.
cash and equivalents Parmalat Group’s assets amounted to Euros 10 billion and its liabilities Euros 7.17 billion. Amongst these liabilities was Euros 1.5 billion in bond debt, launched through 31 different issues. At the beginning of 2003 Parmalat was on the Mib30 index, the index of the 30 largest Italian companies in terms of market capitalisation.

The most distinctive feature of Parmalat’s financial reports was the concurrent high level of cash and debt. Its disclosure policy was characterised by its management’s opaque and arrogant approach towards analysts and investors, similar to Enron. In October 2002 the group launched new bond issues that alerted the market. A Merrill Lynch analyst report of December 2002, titled “The Straws That Break the Camel’s Back,” downgraded Parmalat from “buy” to “sell”. The analyst wrote: “The key issue which continues to perplex us is why the group continues to tap the market for relatively small, yet often quite complex debt issues, when its cash pile continues to rise.”

Indeed, the analyst’s estimate was that Parmalat’s raising money on a BBB - credit rating compared to an implied rate on cash and equivalent of 5.2% had generated a 90bp loss on the spread. Thus, the first conclusion was that “the group is prima facie losing money by running a high level of total debt and total cash.” The second conclusion was that problems could be hidden: “this need for re-financing raises questions as to the underlying cash generation of the group.”

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142 See infra in this par.
143 For accounts of Enron’s opaque financial statements and arrogance, see William W. Bratton, Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders: Enron and the Dark Side of Shareholder Value, 76 Tul. L. Rev. 1275, 1281 (2002).
145 Id., at 5.
146 Id., at 9.
147 Id., at 1.
Other analysts remained apparently unconcerned, even though the details of the group’s financial strategy were unknown and analysts were performing an act of faith in the complexities of its operations. However, the market became more suspicious of Parmalat’s behaviour, a fact clearly evidenced by rumours concerning a new bond issue at unfavourable conditions in February 2003, which hardly hit the company.\(^{148}\) This new issue was officially cancelled. On 6 March 2003 “Assogestioni”, the Italian asset management association, wrote a letter to Parmalat, Consob and Borsa Italiana, denouncing the lack of transparency of the group. As a reaction, Parmalat organized a meeting in Milan on 10 April 2003, during which Tanzi announced that the Group’s CFO, Tonna, had resigned and that a new CFO, Ferraris, was in charge. The market reacted positively and the price soared after the February downturn.

Parmalat’s new CFO, Ferraris, had assured that it would have used only cash to repay the Group debt. However, in June it was discovered that Parmalat had privately placed a new bond, wholly undersigned by Nextra, an asset manager. It is alleged that the conditions and terms were ably arranged by Parmalat and its investment bankers in order to mask the true price at which Nextra was prepared to finance the group.\(^{149}\)

The real amount of all pending bonds was still a mystery. When questioned, Parmalat replied that it had bought back some of its own bonds, but numbers simply did not match. In summer 2003 Consob tried to force the company to be more explicit, but at this stage any communication was raising more problems than it solved. The watchdog started to put strong pressure on Parmalat Finanziaria’s statutory auditors and external

\(^{148}\) “The November 2002-February 2003 period saw Parmalat’s price fall by 45 per cent”: UBS Warburg, 4 March 2003, posted in the Italian Stock Exchange website.

\(^{149}\) Criminal proceedings are pending in Milan against former Directors, former Statutory Auditors, former employees and investment bankers charged with stock manipulation (and other imputations) in relation to the “Nextra Bond”.

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auditors, Deloitte. The latter with reference to 2003 second quarter financial statements informed that it could not give a “fairness opinion” of the true value of Parmalat’s open ended mutual fund Epicurum, recorded as cash equivalent by Parmalat Finanziaria for a book value of Euros 497 million; Deloitte also disclosed the existence of a complex currency swap transaction with the fund. On October 31 Consob wrote a letter to Parmalat, to their statutory auditors and to their external auditors, requesting more information. Parmalat replied that the participation in Epicurum would have been sold immediately. In the meantime, another discovery was made, i.e. the existence of an unreported complex contract between a Swiss subsidiary (Geslat) and a company constituted by Citigroup and named Buconero, the Italian equivalent of Black Hole. This news caused an uproar in the market.

On December 8 2003 Parmalat informed the market that Epicurum was unable to liquidate Parmalat’s interest. The same day a bond was expiring and Parmalat declared that it could not pay it. S&P downgraded Parmalat’s bonds to junk bond status. On December 11 the share price collapsed. Consob asked Grant Thornton, the auditor of a Cayman Islands company named Bonlat, which held a bank account with Bank of America where all Euros 3.95 billion of Parmalat’s group cash was supposedly deposited, to investigate whether Parmalat’s statement concerning the bank account was true. Bank of America replied that the document confirming the bank account was a forgery. In the meantime Parmalat’s management completed the destruction of the relevant company’s documentation and hardware containing evidence of the fraud. Criminal investigations started. On the 27 December 2003 Parmalat S.p.A. was declared insolvent. The same day Tanzi was jailed. On the 8 January 2004 it was the turn of Parmalat Finanziaria: the
group’s insolvency procedure started and Enrico Bondi, a renowned Italiana manager, was appointed as Extraordinary Commissioner.

The technical means used to conceive the huge Parmalat fraud were extremely basic. The group hid losses, overstated assets or recorded non-existent assets, understated its debt, and diverted company cash to Tanzi family members. In order to hide losses, Parmalat had used various wholly-owned entities, amongst which the most significant was Bonlat, the Cayman island waste basket of the Group in its final 5 years, and the holder of the Bank of America’s false account. Uncollectible receivables were transferred from the operating companies to these nominee entities, where their real value was hidden. Fictitious trades and financial transactions were organized to offset losses of operating subsidiaries and to inflate assets and incomes. Securitization schemes based on false trade receivables and duplicate invoices were recurrently used to finance the group. Parmalat understated its debt through different fraudulent schemes. It recorded non-existent repurchases of bonds. It sold receivables falsely described as non-recourse, in order to remove the liabilities from the records. It mischaracterized debt or, simply, did not record it.

Funds were diverted to Tanzi family members and their private companies. A recurrent scheme was to record the payments as receivables and then move the false receivables through the web of the offshore entities in order to blur their true nature. Allegedly, the Tanzi family also channelled repayments for quantity discounts made by Tetra Pak at the end of each year into a bank account held by a company wholly controlled by the family. The funds were used by the family as spending money. In order to understand the dimension of this misappropriation, it is worth noting that Parmalat was

Tetra-Pak’s third largest customer worldwide. The Extraordinary Commissioner of Parmalat has alleged that for the period from 1995 to 2003 the discount payments reached an average of around USD 15 million per year.

Parmalat reveals the features common to firms that have faced catastrophic financial failures: massive growth, questionable accounting and accountants, poor underlying performance, political connections, a dominating shareholder, complex corporate structures and operational mystery. In contrast with other bankrupt firms, however, Parmalat’s governance structures never appeared to be well-designed or state-of-the-art.

**Royal Ahold**

Ahold is a Dutch company at the head of an international chain of supermarkets operating in the United States and Europe in the food retail business. Ahold began as a family business in 1887 and went public in 1948, remaining under the control of the Heijn family, which kept a small stake in the company leveraging on control enhancing mechanisms. In 1989 Ahold, by then the largest food retailer in the Netherlands, underwent a transition to professional management leaving the company with dispersed

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152 See infra, par. *Error! Reference source not found.* Geoffrey P. Miller, *supra* note 151, at 451, observes that collapsed firms usually had well designed or even state-of-the-art corporate governance structures.
153 See www.ahold.com for a profile of today’s company.
154 See A. de Jong, D. DeJong, G. Mertens and P. Roosenboom, ‘Royal Ahold: A Failure of Corporate Governance’, ECGI Finance Working Paper No. 67/2005, February 2005, available at SSRN: http://ssrn.com/abstract=663504, p. 15, stating that, in the IPO, the two sons of the Heijns received founder shares, entitling them to make binding nominations for all the members on the management board and one member on the supervisory board. In the ‘70s, the founder shares were superseded by Dutch company law reform and the ‘structur’ regime was adopted, weakening the powers of shareholders in favor of the supervisory board (Id., at Table 9, for a description of this regime and other takeover defences at Ahold.
shareholders and no major blockholder.\textsuperscript{155} The new management intended to follow the path of Wal-Mart and Carrefour, respectively number one and two retail groups on a global scale, focusing its strategy on the Netherlands, the US and possibly other countries.\textsuperscript{156} Cees van der Hoeven, appointed as CEO in 1992, announced an ambitious plan that foresaw an annual growth of earnings per share of 15 per cent and an aggressive acquisitions’ strategy. As a result, in fourteen years, Ahold acquired 97 companies and entered 26 countries for the first time.\textsuperscript{157} Indeed, Ahold’s ambitious growth targets could only be met with the support of acquisitions and this put considerable pressure on management to do deals.\textsuperscript{158}

The company’s growth strategy in the US was successful, as the retail grocery market, despite being locally concentrated, was nationally fragmented. In addition, Ahold left local structures in place, while realizing network efficiencies.\textsuperscript{159} However, in 1999 the FTC blocked a new acquisition by Ahold on concerns relating to potential market concentration in the East Coast, where the company’s growth had mainly taken place. As a result, Ahold changed its growth strategy in the US, raising doubts amongst analysts.\textsuperscript{160} Moreover, both in Asia and in the European largest markets (UK, Germany and France) the company’s growth strategy failed.\textsuperscript{161} In South America competition from Carrefour and Casino was intense and constrained Ahold’s growth. Furthermore, in 2000 Ahold acquired US Food Service, entering the food services’ industry in which it had no

\textsuperscript{155} A. de Jong et al., note 154, p. 3-4, specifying that institutional investors who became shareholders of Ahold were denied voting rights ‘by exploiting regulations that allow Dutch companies to issue non-voting certificates rather than voting shares’ (see also Id., Table 9).
\textsuperscript{156} Id., p. 5.
\textsuperscript{157} Id., p. 6.
\textsuperscript{158} Id., p. 7.
\textsuperscript{159} Id., p. 9.
\textsuperscript{160} Id., p. 9.
\textsuperscript{161} Id., p. 9-10.
previous experience and expanding rapidly in the same through a change of strategy
difficult to explain.\textsuperscript{162}

In 2001 the company still showed optimism for its future, announcing that it was expecting sales of about €65 billion and would achieve, one year ahead, its three years’ target to double the size of the company.\textsuperscript{163} However, in 2002 its situation deteriorated, as shown by the share price dropping by about 65 per cent throughout the year (from €32.75 to €11.59). Ahold announced that it expected acquisition activity to slow down and warned that the economic crisis in Argentina may result in exceptional charges.\textsuperscript{164} On April 4, 2002 its shares fell 4.8 per cent after its financial statements’ reconciliation to US GAAP showed 2001 net earnings at €120 million, 85 per cent lower than for 2000, while under Dutch GAAP they had risen 36 per cent to €1.11 billion and had been hailed by the CEO as a record just one month before.\textsuperscript{165} In September 2002, the Wall Street Journal wrote that the shopping spree had ended, as Ahold’s debt soared, and that investors were anxious about Ahold’s accounting practices.\textsuperscript{166}

This anxiety was well grounded. On February 24, 2003 Ahold announced that it was restating its reported earnings by $500 million for the years 2001 and 2002 due to a series of accounting inaccuracies related to promotional allowances, which inflated reporting of income from vendor rebates at US Foodservice. In addition, Ahold advised

\begin{footnotesize}
\begin{enumerate}
\item Id., p. 10.
\item See ‘Royal Ahold Hit by Argentine Peso Devaluation’, FT, March 7, 2002.
\item See ‘Ahold Report Clarifies Changes, FT, April 5, 2002; and the Lex Column, FT, April 15, 2002.
\item See ‘Ahold’s Good Times Come to a Halt’, WSJ, September 12, 2002. ‘Customers, worried about terrorist attacks and the economy, turned stingy, particularly at Ahold’s premium supermarkets in the US. Investors then suddenly turned on so-called serial acquirers, worried that billion-dollar shopping binges had hidden a lack of real growth. In addition at the height of investor anxiety about accounting practices, some investors and analysts became concerned about Ahold’.
\end{enumerate}
\end{footnotesize}
investors that it would adjust its previous financial statements to no longer fully consolidate joint ventures in which it did not have a controlling stake. The announcement caused the price of Ahold’s shares to fall by more than 60 per cent, while Standard and Poor’s rating agency cut the company’s debt ranking to junk status. Both the CEO, van der Hoeven, and the CFO, Meurs, resigned. On May 16, 2003 Ahold announced that it would reduce its revenue totals for the last two years by $24.8 billion to properly reflect proportionate consolidation of its joint ventures (ICA, JMR, Bompreco, Paiz Ahold, and DAIH). In fact, an internal investigation had shown that ‘control letters’, which purportedly granted Ahold decision-making authority over these joint ventures providing a basis to fully consolidate the same, were negated by ‘side letters’ that had been concealed to the auditors.

As a result, regulators in the US and Europe launched civil and criminal investigations of individuals and entities associated with Ahold, whereas many class actions and ERISA actions were promoted and subsequently transferred to the District of Maryland. The class action plaintiffs contended that Ahold’s consolidation of its joint ventures and fraudulent accounting of promotional allowances had enabled the company to maintain artificially inflated revenues and strong credit ratings. They also alleged that Ahold senior executives had repeatedly misled investors regarding the company’s financial strength in filings with the SEC and press releases. With specific regard to Van

167 These facts are taken from In re Royal Ahold N.V. Securities & ERISA Litigation, United States District Court for the District of Maryland, 351 F. Supp. 2d 334, 344 ff., making reference to the lead plaintiffs class action complaint.
168 Id., 345, citing the following as agencies conducting investigations: the United States Department of Justice, the United States Attorney’s Office for the Southern District of New York, the Securities and Exchange Commission, the NYSE, the National Association of Securities Dealers, the Office of the Dutch Public Prosecutor, the Euronext Amsterdam Exchange, and the Dutch Authority for Financial Markets.
169 Id., 347.
der Hoeven (CEO) and Meurs (CFO), the class action complaint alleged that they materially misrepresented the Ahold’s financial conditions and its compliance with US and Dutch GAAP, also omitting material facts concerning Ahold’s problems with internal controls and the integration of its many acquisitions. Judge Blake of the District Court of Maryland held, denying (in part) defendants’ motion to dismiss, that there were a number of significant factors leading to the strong inference that both Meurs and Van der Hoeven made at least some of the misleading public statements alleged in the complaint with the requisite scienter. The class action was settled through the payment of $1,100,000 for the claims of class members, as well as attorneys’ fee, costs and expenses.

The case of Ahold reflects most of our qualitative criteria for predicting a financial collapse. First of all, the company underwent a massive and rapid growth, to a large extent through acquisitions. Under CEO van der Hoeven, the group’s total sales raised by more than 6 times in 10 years (from €9,789 million in 1992 to €66,591 in 2001), while operating profit went up 8 times (from €320.7 in 1993 to €2,760.8 in 2001). In the 12 years period from the first appointment of an outside CEO to its collapse (1989-2003), Ahold made 97 acquisitions for a total value exceeding €100

170 Id., 352 ff.
171 First, there were a number of red flags that should have alerted Vann der Hoeven and Meurs to the alleged fraud at USF. One of these arose when James Miller, CEO of US Food, informed Ahold’s executive board of the inadequate internal controls at his company on April 1, 2000. Moreover, Deloitte, the auditor, sent a memo to the same executive board on July 24, 2000, warning that USF’s weak internal controls could adversely affect the company’s ability to record, process and summarize financial data. In addition, Ernie Smith, then the CFO of USF, on April 12, 2001, sent a memo to Meurs, warning that the company’s earnings had been overstated by manipulating allowance income and that there was very little integration of acquisitions.
173 See A. de Jong et al., note 154, p. 33, Table 1 (all data are before the restatement that Ahold published in 2002).
million, while its total assets went up by 12 times (from €1,925 million to 23,399 million).\textsuperscript{174} Ahold’s stock price performance from January 1989 to the date of its restatements’ announcements was zero, with the share price down at €2.8 on February 27, 2003, against €27.5 one year before and €35 two years before (a total drop of 92 per cent over two years, no doubt a considerable value destruction).\textsuperscript{175}

Ahold effected, through the acquisitions of US Food Service and other firms in the same industry, a sudden and drastic change in its portfolio of activities.\textsuperscript{176} As food services are unrelated to the retail grocery market, Ahold became a ‘conglomerate’, with many problems of integration and internal control deriving from the new sector, in which it had insufficient experience. In general, the company’s acquisition spree was financed through both equity and debt issues, with the support of an extensive investor relations program.\textsuperscript{177} Given its frequent issues and strong ties to ABN-Amro, Ahold’s ‘house bank’ which either directly financed its business or underwrote its issues, Ahold had little trouble obtaining financing for its acquisition spree.\textsuperscript{178}

In terms of ‘organization’, Ahold made use of complex corporate structures, as shown by its many joint-ventures (some of which were misleadingly consolidated in its accounts as controlled entities), geographical diversification and difficulties of integration, particularly with reference to the food services’ area.\textsuperscript{179} Ahold’s governance structure, even though not uncommon in the Netherlands, was questionable on many

\begin{footnotes}
\footnotetext[174]{Id., p. 34, Table 2.}
\footnotetext[175]{Id., p. 48, Figure 1.}
\footnotetext[176]{Id., p. 10, speaking of a ‘growth as a goal unto itself’.}
\footnotetext[177]{Id., p. 37, Table 37, for a list of Ahold’s major equity and debt offerings during 1989-2002.}
\footnotetext[178]{Id., p. 22.}
\footnotetext[179]{See, for a list of the numerous Ahold’s subsidiaries and affiliates, the company’s financial statements, e.g. Ahold’s Form 20-F for 2000, Item 19.}
\end{footnotes}
accounts. First of all, a powerful anti-takeover mechanism was in place, with a foundation (SAC) entitled to call preferred shares for a nominal value equal to current capital, a possibility allowing SAC to dilute the stake of an hostile bidder. A second foundation (SAPFA), friendly to incumbent management, controlled the voting rights of the preferred shares held by institutional investors. In addition, under the regime adopted by Ahold, the supervisory board could not only appoint the members of the management board, but also its own members by way of cooptation. As a result, Ahold’s supervisory board was not independent, consisting of former managers and other members tied to various stakeholders; furthermore, some board members were overcommitted, as they participated in many other supervisory boards.

Ahold’s CEO, van der Hoeven, dominated the management board, the members of which owed their positions to him; moreover, his strong and persuasive personality had a major impact on Ahold’s strategy. Ahold’s political connections were evidenced by the fact that four politicians served on its supervisory board. Concerning executive compensation, total remuneration was high to European standards and could easily appear misconceived if stock options were taken into account. The main problem with stock options at Ahold was that the managers were entitled to sell their shares immediately, which they always did cashing in huge profits and avoiding to stay at risk.

180 A. de Jong et al., note 154, p. 42, Table 9.
181 Id., p. 19-20.
182 Id., p. 18-19, citing several Dutch sources to this effect and also stating that Ahold’s management board traditionally provided the nominations for the supervisory board (p. 20).
183 Id., p. 20 and Table 12.
184 See, for information on executive pay in FTSE Eurotop 300 companies in 2002, G. Ferrarini, N. Moloney and C. Vespro, ‘Executive Remuneration in the EU: Comparative Law and Practice’, ECGI Law Working Paper, No. 9/2003, p. 52 ff., showing a CEO total pay of €1,237,354 (mean) and 1,151,700 (median) for Dutch companies (net proceeds from stock options are not included). The total remuneration of Ahold’s CEO in 2002 had been €2,497 million, excluding stock options.
with respect to future performance.\textsuperscript{185} For instance, in 1997 the management board members received net proceeds from stock options equal to 7.5 times their fixed and variable compensation of €6.8 million; in 1998 this ratio was 11.9 (the share price went up from €15.9 at the beginning of 1997 to €31.4 at the end of 1998).\textsuperscript{186} This was clearly inappropriate for a company following an aggressive growth strategy and executing the same to a large extent through acquisitions. A proper remuneration policy would have forced top managers to keep their shares for a time sufficient to prove that their strategy was successful.\textsuperscript{187} This would have created the right incentives for managers not to make acquisitions just for increasing short-term performance, better reflecting on their strategies’ sustainability.

Ahold’s questionable accounting emerged nearly one year before its restatements’ announcement, when investors were disappointed to hear, without prior warning at the time when Dutch financial results were announced, that its net earnings for 2001 were much lower under US GAAP.\textsuperscript{188} In 2001, US GAAP changed the accounting of goodwill in acquisitions, which was not to be amortized anymore, but subject to an impairment test, with impairments charged to the income statement. Ahold reported a goodwill impairment for its Disco joint venture in Argentina, while under Dutch GAAP it was

\textsuperscript{185} A. de Jong et al., note 154, p. 21.
\textsuperscript{186} Id., p. 47, Table 13. In 2002, their total compensation was as high as €20.3 million, while the net proceeds from stock options were €1.6 million (the stock price dropped by 65 per cent throughout that year). In 2003 the management board’s compensation halved to 10.5 million and there were no net proceeds from stock options.
\textsuperscript{187} Several corporate governance codes or guidelines point in this direction. See, for instance, the UK Combined Code, stating in Schedule A, 2: ‘… In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities’. See also the ICGN Remuneration Guidelines, 2006, stating that ‘holding requirements should be an integral component of company’s equity plan and overall compensation philosophy’ (para. 3.4.2).
\textsuperscript{188} See note 165 and accompanying text.
entitled to amortize the goodwill over 20 years. Investors were puzzled by the relevant differences and above all by the fact that Ahold was slow in disclosing them.\textsuperscript{189}

\textit{Vivendi Universal}

Vivendi Universal is the former name of the French company Vivendi S.A., presently active in media and communications.\textsuperscript{190} The company was created as Compagnie Général des Eaux in 1853 to operate in water supply and sewage.\textsuperscript{191} By the mid-1990s its financial conditions had deteriorated and a radical change in management was felt necessary. Jean-Marie Messier, at the time general partner at Lazard Frères, the Paris leading investment bank, was appointed to the post of CEO in November 1994.\textsuperscript{192}

Once at CGE, Messier set in motion a deep restructuring. His overall strategy was to transform the company (in the meantime renamed Vivendi) into a conglomerate focusing on media and telecommunications. However, the water and sewage business still constituted a substantial part of the conglomerate activities. An important development occurred at the beginning of 2000, when Vivendi interrupted its talks for a merger with Mannesmann, which would have saved the latter from Vodafone’s hostile takeover, for setting up Vizzavi, a joint venture with Vodafone on the internet business. The stock market reaction was spectacular: “Within two months of the Vizzavi

\textsuperscript{189} A. de Jong et al., note 154, p. 11-12, citing the Dutch press.
\textsuperscript{190} Vivendi is today a leader in entertainment, with activities in music, TV, cinema, mobile, internet, and games: see the company’s website at http://www.vivendi.com/corp/en/group/profile.php.
\textsuperscript{191} J. Johnson and M. Orange, The Man who Tried to Buy the World: Jean-Marie Messier and Vivendi Universal, 2004, p. 29, stating that CGE’s influence became ‘tentacular’, from water and sewage to heating, transport, cable television, cinemas, etc. In addition, as owner of France’s second-largest construction company CGE was also one of the biggest land and property owners in the country.
\textsuperscript{192} Id., p. 30-33. In 1996 Messier replaced Dejouany also as Chairman of CGE, becoming a Président-Directeur General (PDG) in the French tradition of powerful CEOs.
announcement, Vivendi’s shares had soared 130 per cent from their mid-November lows to reach €142, six times their value at the moment of Messier’s arrival.”\textsuperscript{193}

A major change occurred with the merger between Vivendi and Seagram, a Canadian corporation active in the spirits industry, which was controlled by the Bronfman family. Seagram had a large share of the US beverages market and was also present in the entertainment industry through MCA, owner of Universal Pictures, and PolyGram, the leading music company.\textsuperscript{194} At the end of the ’90s the Bronfman\textsc{es} decided to dispose of their shareholding in Seagram, cashing-in the record valuation of the company, mainly due to the increased value of its media assets. A merger was their favorite option, particularly after the AOL/Time Warner deal showing the value of convergence between communications and entertainment.\textsuperscript{195} Also Messier was looking for a partner, after his failed attempt to merge Vivendi with Mannesmann; moreover, he wanted to exploit the exceptionally favorable valuation of Vivendi’s shares, further enhanced by the Vizzavi deal.\textsuperscript{196}

Vivendi Universal, as the corporation was renamed after the merger with Seagram, invested more than $50 billion over two years in acquisitions, generating goodwill of more than 45 billion, to create “a content generation and distribution

\textsuperscript{193} Id., p. 53.
\textsuperscript{194} Id., p. 65 ff.
\textsuperscript{195} Id., p. 71.
\textsuperscript{196} Id., p. 72-75. For Seagram an essential condition of the merger was that Vivendi, which owned a minority stake of Canal Plus, acquired control of the latter, so that Universal could benefit from an important distribution platform in Europe. This increased the cost of the merger for Vivendi to nearly $60 billion (43 billion for Seagram and 15 for Canal Plus). Vivendi offered $77.35 per share, based on a ratio of 0.7 Vivendi share for each Seagram share, representing a premium of 54 per cent.
conglomerate.” These acquisitions boosted VU’s debts, at a time when, particularly after the collapse of Enron, investors had become extremely cautious about acquisitive and highly leveraged companies. Especially onerous was the purchase for $10.3 billion of the majority stake in USA Networks, in which VU had a 49% holding. As later alleged in an investigative report by the Wall Street Journal, VU's board approved this transaction unaware that “Vivendi was already in dire financial straits.” In addition, Messier made large recourse, throughout 2001, to share buy-backs, directed to support the valuation of shares, which had dropped precipitously. By December 2001 VU held 104 million of its own shares, representing 9.9% of its capital. As a result, VU accumulated a net debt of $28.9 billion at the end of 2001, which was also a reflection of the ease with which banks extended credit to the company.

Vivendi’s investments in the new sectors often lacked coherence amongst themselves, were not always profitable and in some cases consisted of minority stakes.

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198 See Johnson and Orange, note 191, p. 117.
199 Messier described the deal as creating ‘a new US major (television powerhouse), which will benefit from the full integration of TV and movies activities with production and distribution’: see Agence France Press, 17 December 2001, ‘Vivendi Universal buys USA Networks in titanic media expansion’.
200 See How Messier Kept Cash Crisis at Vivendi Hidden For Months; Media Giant Was at Risk Well Before Investors Knew, Wall Street Journal, October 31, 2002, A1. Just the day before “unknown to investors and the Vivendi board, the company had narrowly averted a downgrade by credit-rating agencies, which would have made it difficult to borrow money and plunged the company into a cash crisis.” When the board met the following day “Messier made no mention of the close call with the rating agencies. Instead, when a director asked about Vivendi’s financial profile, Mr. Messier said the company had no problem, according to two directors who were there.”
201 See Johnson and Orange, note 191, p. 153, quoting Claude Bébéar, chairman of Vu’s finance committee, saying: “Over two and a half years, the group spent $11 billion repurchasing its own shares, at a loss of 5.3 billion.”
202 See the FT’s Lex Column of 26 july 1999: ‘Vivendi has switched from restructuring mode – selling 15 bn of business – to predator before proving it can squeeze a good return from the core business. The Group remains relatively unfocused and has issued a slew of new paper’.
VU kept investing in the internet business, even when it became clear that profitability would take longer to emerge in this area. In a sense, the conglomerate nature of Vivendi was enhanced by the merger with Seagram, making it even more difficult to investors to appreciate the logic of combining so different businesses. Analysts expected Messier to complete VU’s transformation into a more coherent group and to dispose of its controlling stake in the water business as soon as this became feasible on taxation grounds.

As the prices of media assets dropped dramatically, VU had to adjust the value of the goodwill generated on acquisitions, writing €15.2 billion off its balance sheet. This determined a total loss for 2001 of €13.6 billion, the biggest in French corporate history. Moreover, VU had liquidity problems, despite its management efforts to conceal them. In order to raise €3.3 billion, in January 2002 Messier sold the company’s own shares to Deutsche Bank and Goldman Sachs for a placement on the market. This ran against the promise to cancel the VU’s own shares, which had been made by Messier to investors not

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203 See, e.g., ABN-Amro, Media Sector Research, ‘Vivendi Universal: Water into Wine?’ , July 2001, p. 4: ‘VU poses some interesting questions for the investor. Part telco, part media major, part pay-TV company, part utility; it represents a unique investment opportunity in a global context … Despite its short-term attractiveness, we believe VU in its current state is not an attractive investment proposition. The challenge for VU is to convince the market that its strategy of vertical integration is the right one and that it has successfully completed the transition from a water company into what we define as a Worldwide Integrated Networked Entertainment (WINE) company’.

204 Id., p. 1: ‘we expect VU to make a number of changes to its business portfolio. It must gain a foothold in the US marketplace by buying broadcasting, cable and internet assets. However, its status as a French company may make this a difficult task, given foreign ownership restrictions’. See also the FT’s Lex Column, 9 february 2001, stating: ‘Hollywood movies and French sewage do not make an attractive long term combination’.

205 See Morgan Stanley, Equity Research North America, ‘Vivendi Universal: Upgrading to Outperform’, p. 4: ‘Vivendi Universal has openly expressed its intention to deconsolidate its interest in Vivendi Environment. While VU can not reduce its stake before 2003 due to tax considerations, its stake could drop below the 50% threshold if Vivendi Environment merged with another environmental concern. The deconsolidation of Vivendi Environment, coupled with the divestiture of Vivendi’s Universal non-core assets (mostly in the telecom sector), should make comparisons with pure play entertainment companies easier’.
long before. In addition, the transaction highlighted the company’s strong need for cash, also considering that the shares were sold for €60 each despite having been purchased for an average price of €73.\textsuperscript{206} However, the gravity of VU’s financial conditions was not fully perceived by analysts and investors, who were frequently reassured by management in terms that later led both the SEC and class actions plaintiffs to allegations of financial fraud.\textsuperscript{207}

At the beginning of May 2002, Moody’s announced that VU’s rating would be reduced to just one notch above junk status, which obviously impaired the company’s access to the bond and commercial paper markets.\textsuperscript{208} Moreover, the company’s share price continued to fall, triggering the put options issued to third parties when the share price was at much higher levels. In addition, Cegetel demanded repayment of all amounts lent to VU upon request from British Telecom, a Cegetel’s minority shareholder who invoked its shareholders agreement with VU to this effect.\textsuperscript{209} In a desperate effort to raise funds, on June 12, 2002, VU entered into a repo transaction with Deutsche Bank for €1.4 billion with respect to a 12.7 stake in Vivendi Environment. Unsurprisingly, the news of this transaction was received as alarming evidence of a cash shortage by the equity market, which sent VU’s share price further down to below €25.\textsuperscript{210} On June 24, the share

\textsuperscript{206} Id., p. 162-163.
\textsuperscript{207} See notes 215 and 219.
\textsuperscript{208} See Johnson and Orange, note 191, p. 205, citing the rating agency’s diplomatic warning: “The company is unlikely to achieve meaningful excess cash flow during the current financial year once the outflow for its 2001 dividend is taken into consideration,” that the authors interpret in the sense that “the company was entirely dependent on the goodwill of the banks to roll over its short-term borrowings.”
\textsuperscript{209} Id., p. 215.
\textsuperscript{210} Id., note 191, p. 219.
price took a further plunge to €18, its lowest level since May 1989.\textsuperscript{211} Nonetheless, on June 26 the Dow Jones International reported that Messier had opened an investor conference call by saying: “We feel very confident looking to our debt and cash analysis with all our commitments of the group for the coming 12 months.”\textsuperscript{212} The final blow to VU and Messier came from two of the major French banks refusing to extend further credit. At the beginning of July, Messier resigned, after negotiating a severance package worth more than €20 million, and was replaced by Jean-René Fortou, who had already successfully managed a major French company, Rhône-Poulenc, helping to restore it to health in the '90s.\textsuperscript{213} The new CEO later stated that when he took over “if Jean-Marie Messier had stayed at the head of Vivendi Universal, the company would have filed for bankruptcy within ten days.”\textsuperscript{214} Fortou rapidly dismantled VU's empire by selling assets and focusing the group on its present businesses (music, TV, cinema, mobile, internet, and games).

In the meantime, investigations were conducted by the French and US securities regulators, and class actions were brought against VU and its officers. The SEC acted well ahead of its French counterpart with a civil fraud action alleging several accounting and disclosure irregularities;\textsuperscript{215} however, this action was simultaneously settled with the

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\item[\textsuperscript{211}] See Johnson and Orange, note 191, p. 221 ff., also describing VU's board games which led to the ousting of Messier. Indeed, the deepening of the company's financial crisis reunited the board, which had been for some time divided between a French majority supporting the CEO and an America minority fighting against him.
\item[\textsuperscript{212}] See the Class Action Complaint, note 219, ¶106.
\item[\textsuperscript{213}] See Agence France-Presse, 3 July 2002, 'Vivendi Universal names Fortou to succeed Messier'.
\item[\textsuperscript{214}] See the Class Action Complaint, note 219, ¶186.
\item[\textsuperscript{215}] See the SEC complaint of December 23, 2003, in Securities and Exchange Commission v. Vivendi Universal, Jean-Marie Messier and Guillaume Hannezo, United States District Court, S.D. New York. The SEC alleged that VU, in addition to falsely portraying its liquidity position, had made improper adjustments that raised EBIDTA 'so that Vivendi could meet ambitious earnings targets that it had communicated to the market'. Moreover, VU had failed to disclose future financial commitments regarding two of its subsidiaries and to disclose all of the material
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company paying $50 million in civil money penalties to go to investors harmed by the fraud and Messier relinquishing its claim to a $21 million severance package.\textsuperscript{216} The Autorité des Marchés Financiers (AMF), with its decision of November 3, 2004, fined VU and Messier for misleading financial information in the amount of €1 million each, the highest fine ever of the French securities regulators against an individual.\textsuperscript{217} These fines were however reduced to €300,000 for VU and €500,000 for Messier by the Paris Court of Appeal.\textsuperscript{218}

The Vivendi Group, during the period of its maximum growth, had easy access to the capital markets, at least until when its liquidity problems were not manifest; moreover, its “overvalued” equity made acquisitions “cheaper”, creating a perverse incentive to purchase firms even in the absence of a clear industrial logic.

Management’s communication strategy was directed to support the value of shares and the recourse to debt financing, even at the cost of concealing serious liquidity problems. For instance, according to the class action complaint: “On December 6, 2001, … Messier assured the investing public that Vivendi ‘is in a very strong position, with solid performance in virtually every business.’” One week later – after announcing that it would raise $2.5 billion by selling a $1.5 billion interest in BskyBand a $ 1.06 billion interest in Vivendi Environment – Vivendi stated, as reported by the Financial Times (London) on December 14, 2001, that these asset sale would give Vivendi “room to

“maneuver” for additional acquisitions, and enable it “to cover any eventual needs from
different opportunities for strategic partnerships.” As late as on June 26, 2002, the Dow
Jones International reported that Messier had opened an investor conference call by
saying: “We feel very confident looking to our debt and cash analysis with all our
commitments of the group for the coming 12 months.”

Vivendi’s group structure was complex, given its multinational reach and
diversity of businesses. The board of directors was apparently dominated by the CEO and
either unable or unwilling to challenge his spending spree, which nearly brought the
company to disaster. Moreover, the board appeared to be split between a French majority,
tied to Messier by social networks and interlocking directorates, and an American
minority, close to the Bronfmans and increasingly hostile to the CEO. The formal
requirements of corporate governance, such as a committees' structure, the presence of
independent directors and frequent meetings of the board, were complied with. More
interestingly, the board was able to find unity amongst its members when the liquidity
crisis emerged. After receiving advice from Goldman Sachs on VU’s near insolvency, the
board fired the CEO, a move almost unprecedented in French large corporations. This
allowed VU to avoid bankruptcy and go through a deep and successful restructuring.

See United States District Court, S.D. New York, In re Vivendi Universal S.A., Securities
Litigation, First Amended Consolidated Class Action Complaint, November 24, 2003, ¶ 79.
Similarly, on December 17, 2001, Messier held a press conference with Barry Diller, Chairman
and CEO of USA Networks, to discuss the acquisition of this company's assets by Vivendi, and
declared: 'At the end of the day, this transaction is not putting pressure on Vivendi Universal. On
the reverse, what it allows us to do is to increase our EBITDA target for 2002 by more than ten
percent. It's to increase our net income in 2002 by roughly 200 million dollars. It's to increase the
net free cash flow of the group in 2002 by, let's say three hundred and fifty million dollars'. Id., ¶ 81.

See the Class Action Complaint, note 219, ¶106.

See Johnson and Orange, note 191, p. 170, also highlighting differences in directors' behavior
across the Atlantic.
Vivendi was dominated by an almighty CEO, assisted by a 'dream team' of four managers, including two old friends of Messier.\textsuperscript{222} Political connections were very important for VU. On the one side, former Général des Eaux had already been involved in more or less transparent political sponsorships;\textsuperscript{223} on the other, Messier had the typically French profile of the high-ranking civil servant turned into a successful and well-connected corporate manager. First, the studies at Ecole Polytechnique; second, the education at Ecole National d’Administration (ENA), the graduates of which (so called \textit{énarques}, including four former presidents of the French Republic) still dominate the French political and economic scenes; third, the appointment as \textit{inspecteur des finances} and the work at the economy and finance ministry (then run by Edouard Balladur, a heavyweight member of Chirac’s government).\textsuperscript{224} One may add that in France, large firms, even those not controlled by the State, are often subject to political influence and interference; this was true also for VU, which unlike other large firms had no controlling shareholders.

Management was also keen to lavish expenditures, as shown by just two examples. VU bought, as a residence for Messier moving to New York to lead the group from there, a Park Avenue apartment worth $20 million. Once established in New York, Messier bought an Airbus A319 to add to VU’s fleet of corporate jets, save for denying

\textsuperscript{222} Id., p. 35.
\textsuperscript{223} See J Johnson and M Orange, note 191, p. 30, stating that CGE’s primary rival in the public utilities market was Lyonnaise des Eaux: ‘Both groups used all the means at their disposal to win municipal contracts. Taking advantage of the deliberately opaque party-funding laws, they became important sources of funding for the major political parties’.
\textsuperscript{224} Id., 19-21. Messier was in charge of privatizations, a core aspect of the French liberalization policy after the nationalizations occurred under the first Mitterand’s presidency. This allowed Messier to meet the French business elites and establish a network of acquaintances that turned out to be very useful at Lazard, where he became a managing director immediately after leaving government, just before the second Mitterand’s presidency.
its existence once a public affair was mounted in Paris about this waste of corporate wealth.\textsuperscript{225} Also top management compensation appeared to be excessive, as shown by Messier receiving for 2001 a 250 per cent bonus, taking his salary to €5.12 million, when VU registered the largest loss in French corporate history. As to stock options, in five years at VU Messier received 2 million of them, roughly a third of 1 per cent of total share capital, that in 2000 were worth around €22 million.\textsuperscript{226} His severance package, in the amount of €20 million, reflected similar excesses.

VU’s accounting did not attract much criticism, save for the confusion possibly created by the existence of two sets of accounts (one under French and the other under US GAAP), after the merger with Seagram and the cross-listing of the company’s shares. One of the most serious allegations of fraud with respect to VU’s accounting was moved by the SEC alleging that the company and its officers had perpetrated an accounting fraud by consolidating Cegetel despite the fact that VU had no access to the former’s cash flow.\textsuperscript{227} Similarly, Judge Baer for the S.D. Court of New York, in adjudicating a defendants' motion to dismiss in the class action brought by VU shareholders, held that both under French and US GAAP the restrictions to access the liquidity of Cegetel could make the consolidation of the latter company in VU financial statements improper.\textsuperscript{228}

\textsuperscript{225} Id., p. 176-177.
\textsuperscript{226} Id., p. 108-109, 214-215.
\textsuperscript{227} See the SEC complaint of December 23, 2003, in Securities and Exchange Commission v. Vivendi Universal, Jean-Marie Messier and Guillaume Hannezo, United States District Court, S.D. New York, arguing: ‘In fact, at year-end 2001 and during the first half of 2002, Defendants and other senior executives of Vivendi knew or were reckless in not knowing that the Company's overall cash flow was "zero or negative" and that Vivendi "produced negative cash flow from [its] core holdings" such as its entertainment businesses "that [was] barely offset by inaccessible cash flow from minority interests" such as Cegetel and Maroc Telecom. These factors hindered Vivendi's ability to reduce its debt and meet its cash obligations, and resulted in a liquidity condition that was in stark contrast to the representations made by Vivendi in public statements’.
However, an opposite conclusion was later reached by the French regulator and the Paris Court of Appeal, holding that the consolidation of Cegetel and Maroc Telecom was proper.\textsuperscript{229} As already stated, the main allegations of fraud, both from the regulators and the class action claimants, were those concerning management’s misstatements directed to conceal VU’s liquidity problems.

\textit{Worldcom}

WorldCom began life in 1983 as a startup provider of discount long-distance services, based in Brookhaven, Mississippi, a small town about an hour south of Jackson.\textsuperscript{230} The company is said to have originated from a note scribbled on the back of a coffee-shop napkin.\textsuperscript{231}

The dominating figure at WorldCom, Bernie Ebbers, was a folksy former basketball coach. Ebbers’ story, at least as it was embellished prior to his disgrace, has some of the mythic elements one associates with figures from American folk history such as Abraham Lincoln. Born to a poor family in Edmonton Alberta, Ebbers took a job delivering milk after graduating from high school, sometimes in temperatures that “reached 30 degrees below zero.”\textsuperscript{232}

Ebbers took WorldCom from essentially nothing to one of the giants in the telecom industry. He was, as Forbes.com described him, “the visionary who stitched it together like Frankenstein's monster from pieces of the many firms he acquired over the

\textsuperscript{229} See the references at notes 217 and 218.
past two decades."\textsuperscript{233} Under Ebbers’ domination Worldcom displayed an insatiable appetite for growth. It made more than 70 acquisitions in a twenty year period, including the largest merger to date in U.S. history, the acquisition of MCI. In October 1999 Worldcom announced its intention to acquire Sprint, the third-largest U.S. telecom, for $115 billion. Despite intense lobbying, Ebbers and his team could not convince the antitrust regulators to approve the deal.\textsuperscript{234}

Worldcom experienced spectacular stock market returns during its period of peak growth, reaching an all-time high of $96.76 in June 1999. Between 1989, when the firm went public under the name LDDS Communications, and its peak in 1999, WorldCom’s shares increased an astounding 7,000 percent.\textsuperscript{235} Its share price headed into the stratosphere, propelled by market enthusiasm for high-tech investments, the dot com bubble, and the extraordinary marketing skills of Ebbers and his Chief Financial Officer, Sullivan.

Worldcom engaged in massive lobbying. Ebbers himself donated generously to politicians from both parties, and the firm’s corporate culture strongly encouraged – some might say compelled – other executives to do the same. WorldCom gave $7.5 million on politicians since 1989. Republicans got 54% of it, and Democrats 46%. For the 2002 election, the company split $1 million in donations 50-50 between the parties.\textsuperscript{236}

The fraud at Worldcom began in 2000 as the telecom bubble began to deflate. Although Worldcom’s corporate structure was unusually complex, the fraud itself was

\textsuperscript{233} Mark Lewis, The Rise And Fall Of Bernie Ebbers, April 30, 2002.


\textsuperscript{236} See As business scandals mount, both parties share blame, USA Today, July 8, 2002, available at 2002 WL 4729246.
rudimentary: Worldcom booked line costs as capital expenditures rather than as operating expenses that needed to be accounted for during the fiscal year. The result was to inflate Worldcom’s stated earnings before interest depreciation and amortization. Eventually the company could not continue to hide the bleeding. Bernie Ebbers resigned on April 2002 amid complaints about poor stock performance and allegations of impropriety in connection with the company’s guarantee of a margin loan against Ebbers’ stock holdings. The fraud came to light on June 25, 2002 when Worldcom announced a $4 billion restatement of its financial statements and fired CFO Scott Sullivan and accepted the resignation of Controller David Myers. The following day the SEC commenced a civil securities fraud case against Worldcom. On July 21, 2002 Worldcom filed what was then the largest bankruptcy in U.S. corporate history. It emerged from bankruptcy in 2004 under the name of MCI and was purchased by Verizon in 2006.

In March 2005 Ebbers was convicted after eight days of jury deliberations and sentenced to 25 years in prison. He is now serving time in the Oakdale Louisiana Federal Correctional Institution and is scheduled for release in 2028. ²³⁷

III. Possible Red Flags

Given these case histories, are there any commonalities in our fraud firms that might help distinguish them from other firms where fraud is not present? In this section we identify a number of possible commonalities.

1. It appears that many firms in our sample displayed domination by an individual or small group. This feature is also identified as a red flag in SAS 99, the official standard for external auditors. Domination of this sort appears to facilitate fraud because it tends to exclude the ordinary supervision and oversight that corporate checks

²³⁷ See Corporate convicts: Where are they now?, Fortune, June 2, 2008.
and balances would otherwise provide. There may also be a psychological dimension: a single dominating individual or small group may tend to display aggressive personalities who may be more inclined to rationalize or justify fraud when the motivation or opportunity presents itself. In our judgment, all but one of the cases in our sample (Lernout & Hauspie) displayed this feature.

2. It appears that many firms in our sample displayed massive growth in the period several years preceding the fraud. Massive growth may be a proxy for fraud for several reasons. When a firm displays massive growth it is likely to commit itself to unsustainable projects for the future which then result in reduced profits down the line. Massive growth greatly complicates the task of auditors and others who are seeking to understand the firm’s operations, since a firm which is growing rapidly does not present a baseline which can be used to identify unusual changes that may be the fingerprints of fraudulent accounting. Massive growth can also represent an attempt by the incumbent managers to disguise the results of past frauds by growing out of the problem. All of the cases in our sample displayed massive growth during the three to five year period preceding the discovery of the fraud.

3. Some of the firms in the sample displayed drastic changes in business or operations during the period three to five years before the discovery of the fraud. Drastic, sudden changes in fundamental operations can be a proxy for fraud because they can obfuscate poor results of operations or provide an innocent explanation for why things suddenly turn bad. Such changes may also predict fraud because they may represent risky new ventures which, if they fail, will present management with the incentive to engage in fraud in order to avoid acknowledging their error. Only four in our sample
turned out to display drastic changes in core business: we judged that Enron, Parmalat, Royal Ahold and Vivendi Universal displayed this feature at least to some substantial degree, but the other six firms did not.

4. Our case studies present several firms that appear to have operated in an atmosphere of operational mystery. They appeared to function well, and have a good reputation, but there was an undercurrent of concern that the source of profitability or revenues could not be clearly identified for reasons such as the new or untried nature of the business plan or the complex corporate structure that involved partnerships or joint ventures with other firms. Enron is a classic example of a firm displaying operational mystery. We concluded that this feature was present to a substantial degree with respect to Aldelphia, Computer Associates, Enron, Parmalat, Royal Ahold, and Vivendi.

5. We investigated whether the firms in our sample displayed poor formal corporate governance. Poor corporate governance in this context would mean, for example, a board of directors dominated by a controlling shareholder or senior managers, a lack of an independent audit committee, or some other breakdown in the checks and balances that are found in most major corporations. Somewhat surprisingly, we found that the large majority of firms in our sample did not display poor corporate governance in this sense. In fact, in our judgment, only Parmalat and Royal Ahold are properly classifiable as lacking in corporate governance protections at the time the accounting irregularities occurred. Some companies – Enron being a prime example – displayed “state-of-the-art” corporate governance rules: the majority of Enron’s board of directors were independent, capable, and highly accomplished individuals; the company maintained a fully independent audit committee; and its compliance operation appears to
have been at least on a par with those of other major corporations. We interpret this finding as suggesting that formal corporate governance procedures, without more, cannot be relied on as a sure bulwark against fraud in companies where senior managers conspire to cook the books.

6. It appears that many firms in our sample had easy access to capital with poor monitoring by the capital provider. The frauds in several of the sample companies took place in the environment of industry-wide bubbles where capital was readily available to any firm that could claim to be a reputable player in the market. Our sample firms appeared to further enhance their access to capital by the assiduous courting of their public image and by their attempts – not always diplomatically executed – to influence analysts to promote their securities with the investing public. In our judgment, most of the firms in the sample enjoyed easy access to capital without strong monitoring by the capital suppliers: Adelphia, Enron, Global Crossing, HealthSouth, Royal Ahold, Vivendi and Worldcom appear to fall in this category.

7. Several of the firms in our sample appear to display an overly complex corporate structure, either with respect to the network of parent and affiliate companies, the relationships with joint venture or structured finance partners, or both. Complex structure is another of the red flags identified by the auditing community as a red flag of fraud in SAS 99. This feature appears to be a potential proxy for fraud because a complex corporate structure can obfuscate understanding of the company’s operations by external auditors, internal auditors, analysts, and regulators alike. Because complex corporate structure is in itself costly, unless it can be justified by some legitimate business or tax reason, a natural inference is that the company is using the complex
arrangements to hide something that it does not wish disclosed. In our judgment several, but not all, the firms in our sample displayed complex corporate structure: Adelphia, Enron, Lernout & Hauspie, Parmalat, Royal Ahold and Vivendi fell into this category.

8. Our case histories reveal that several of the firms in our sample appear to have assiduously courted politicians and attempted to curry favor with the public in various ways. The courting of politicians might be associated with an enhanced fraud risk either because the managers who solicit political support have a mindset that seeks to avoid complying with the law by means of mutual favor-giving, or because they anticipate the possibility of being accused of misconduct and seek to line up advance support to ward off or respond to such accusations. We found the currying of political support to be strongly present in our sample. In our judgment, all the firms on our sample except for Computer Associates manifested this characteristic to a substantial degree.

9. Press accounts of our firms tended to emphasize the lavishness of the firms’ expenditures on items such as buildings, events, and compensation for employees and senior managers. Similarly, these accounts often appear to describe over-the-top ostentation in personal expenditures by the dominating figure or figures in the firms. Lavish expenditures could be proxies for fraud because they manifest a managerial mindset that is willing to cut corners in order to achieve short-term gratification, or because the expenditures themselves use up firm resources and thus generate pressures to cover the costs by increased profits. In our judgment, the following firms were described in press accounts during the period of the fraud as engaging in unusually lavish expenditures: Adelphia, Enron, Global Crossing, HealthSouth, Parmalat, Vivendi, and Worldcom.
10. We noted that the firms in our case studies sometimes supported or owned prominent sports teams or franchises. While this item is obviously of lesser importance than others, and many perfectly legitimate companies own or are associated with sports teams, the factor is perhaps not irrelevant. Ownership or prominent association with a sports team could be an indicator of fraud because it might suggest an overly heightened concern with burnishing a company’s public image, or because it might reflect the excessive power of a dominating figure who uses the corporate assets to indulge a personal interest. The following firms in our sample owned or were prominently associated with a sports team: Adelphia, Computer Associates, Enron, Global Crossing, and Parmalat.

11. Obviously, the financial frauds would not have occurred in these public companies if all of the auditors and accountants had properly and accurately performed their jobs. Improper accounting, however, cannot function as a red flag of fraud if it is uncovered after the fraud has come to light. But if the auditing is publicly questioned prior to the disclosure of the fraud, this may be a possible danger signal. We found, however, that serious questions about accounting or auditing were raised with respect to surprisingly few firms in our sample prior to the revelation of the fraud. In our judgment, only Computer Associates, Lernout & Hauspie, and Royal Ahold fell in this category to any substantial extent. For most of the firms in the sample, we found no indication of serious public concern about accounting practices before the disclosure of the frauds.

12. SAS 99 lists rapid turnover of senior managers as one of the danger signs of financial fraud. The theory may be that senior managers who have the backbone to question an ongoing fraud are dismissed, or that their short job tenure disables them from
uncovering misconduct that would be apparent to one with a longer period of service. We doubted this theory, ex ante, because a fraud appears much more likely to be sustainable if managed over time by a small and close-knit group. We judged that this factor was nearly absent from the firms in our sample: only HealthSouth displayed short job tenure for senior officials associated with the fraud (alarmingly, in the case of that company, all five individuals who served as chief financial officer were convicted of criminal activities in connection with the fraud at that firm).

13. Finally, we investigated the Arthur Anderson factor. Given the bad reputation that attached to Anderson as a result of Enron, was that firm conspicuously present as external auditor in our fraud firms? It appears that Anderson did audit a disproportionate number of these firms (3 out of ten) relative to Anderson’s share of the auditing market, but Anderson hardly had a monopoly on audits of firms committing major frauds (Deloitte & Touche and KPMG were each close seconds, with two firms each).

The results of this analysis are summarized in Table 1:

[Insert Table 1 here]

Overall, on the basis of our study, we consider it appropriate to take as somewhat reliable red flags of fraud any factor that is manifested in six or more of the cases. Judged by this criterion, the following quantitative factors may be considered red flags of serious financial fraud at publicly traded companies: (1) domination by an individual or small group; (2) massive growth; (3) operational mystery; (4) easy access to capital with poor monitoring or controls; (5) unnecessarily complex corporate structure; (6) unusual or substantial involvement in currying influence with politicians; and (7) lavish
expenditures. The following factors were judged not present in a sufficient number of our firms to qualify as red flags of financial fraud: (1) drastic changes in the fundamental nature of the business; (2) poor formal corporate governance; (3) ownership or prominent association with a professional sports team; (4) questioned accounting; (5) rapid turnover of senior managers, or (6) the presence of Arthur Anderson as auditor (which, given Anderson’s demise, could not constitute a red flag in any event).

IV. Quantitative Indicators

In this section we turn from qualitative to quantitative indicators. We explore the behavior of stock price levels and volatility during instances of corporate fraud. It is clear from our narratives that firms engaging in fraudulent activities share certain commonalities such as sudden and rapid revenue growth, large and numerous acquisitions and complex corporate structures. We show that these commonalities translate to a distinct set of stock price dynamics that in turn reflect changes in firm sensitivities to systemic risk.

Below are plots depicting the relative share price performance of seven of our fraudulent firms against a handful of similar companies and indices. In order to facilitate an accurate comparison, we set a base period in which all prices are normalized to 100. For all stocks listed before 1997, our comparison begins from a base period of January 2\textsuperscript{nd} 1997 while the Global Crossing base period is set to September 1\textsuperscript{st} 1998.\textsuperscript{238} In the cases of Adelphia, Enron, Lernout, Global Crossing, WorldCom and Vivendi (depicted in Figures 1 – 6) it is clear that their stock prices experienced spectacular growth relative to their industry counterparts and market indices before suffering steep declines as frauds are uncovered. We also note that in all five cases, the stock prices experienced major

\textsuperscript{238} Global Crossing was listed on the NASDAQ on August 18\textsuperscript{th} 1998.
declines before the frauds are made public. A similar pattern of rise and sudden decline can also be seen in the remaining two firms, Ahold and Computer Associates though the magnitude of their stock price movements are small relative to comparable firms and market indices.

Figure 1:
Figure 2: Enron Price Comparison: Base Period 1/2/1997

Figure 3: Lernout Price Comparison: Base Period 1/2/1997
Figure 4:

Global Crossing Price Comparison: Base Period 9/1/1998
Figure 5:

Worldcom Price Comparison: Base Period 1/2/1997

Figure 6:

Vivendi Price Comparison: Base Period 1/2/1997
Figure 7:

Ahold Price Comparison: Base Period 1/2/1997

Figure 8:

Computer Associates Price Comparison: Base Period 1/2/1997
These plots suggest that activities which we have associated with fraudulent behavior may be reflected in stock price dynamics. While it is clear that false reporting and artificial inflation of revenues and profits do lead to higher stock valuations, it may also be the case that the activities which help facilitate fraud will lead to higher returns in the form of a risk premium. Specifically, as firms make rapid acquisitions and become increasingly complex and levered, they must also necessarily become riskier investments thus translating to higher returns and volatility. To further explore this relationship we employ the standard Capital Asset Pricing Model (CAPM) as a means of quantifying the changes in the riskiness of firms as they engage in fraud. The CAPM implies that the risk of an asset is measured as the normalized covariance of the returns on that asset with the returns on the aggregate wealth portfolio, which we proxy by a value weighted portfolio computed by the Center for Research in Security Prices (CRSP). This value, typically denoted as $\beta$ represents an asset’s sensitivity to systemic or market risk.

To explore the time variation of the riskiness of our firms of interest as represented by $\beta$, we utilize realized second moments of returns as developed by Schwert (1989), Anderson, Bollerslev, Diebold & Labys (2003), Barndorff-Nielsen & Shephard (2004) and others. Their work provides the theoretical foundation for the use of time series of realized second moments as the basis for modeling the dynamics of volatility and covariance. The realized covariance of a stock $i$ and the aggregate wealth portfolio between the end of month $t$ and the end of month $t+n$ is measured as

$$\sigma_{i,p}(t,n) = \frac{1}{2n} \sum_{d=t}^{t+n} r_{i,d} \times r_{p,d}$$

Where $[t_1, t_D]$ denotes the sample of available daily returns between the end of month $t$ and the end of month $t+n$ and $r_{i,d}$ and $r_{p,d}$ are the returns on stock $i$ and the aggregate
portfolio respectively on day $d$. Following standard practice in the literature on realized second moments, the number of days in a month is normalized to 22 and the mean correction is omitted. Similarly, the realized volatility of a stock between the end of month $t$ and the end of month $t+n$ is given by

$$\sigma^2_{i,t}(t,n) = \frac{1}{22n} \sum_{d=1}^{n} r_{i,d}^2$$

It follows that the realized CAPM beta between the end of month $t$ and the end of month $t+n$ is given by

$$\beta_{i,t}(t,n) = \frac{\sigma_{i,p}(t,n)}{\sigma^2_{i,t}(t,n)}$$

Figures 9 – 16 plot the realized CAPM betas for our 8 firms. In all cases there are distinct shifts in the average values of beta over time. More importantly, there appear to be positive shifts during periods in which both companies conducted activities associated with fraud. For instance, in the case of Vivendi, a shift appears to exist in late 2001, following a period of intense acquisition and diversification of its businesses.

Figure 9:
Inspection of the Lernout and Hauspie plot reveals a shift in its CAPM beta beginning in late 1997 and lasting until early 1999, a period in which the firm recorded dramatic revenue growth largely derived from acquisitions and improper reporting. The remaining
time series plots also reveal significant variation in realized betas during periods of fraudulent activity.

Figure 12:

Figure 13:
Figure 14:

Vivendi 3 Month Realized Beta

Figure 15:

Ahold 3 Month Realized Beta
When we compare the realized betas depicted in the plots above with those associated with firms that have not exhibited any evidence of fraudulent activity, the difference in variation is stark. Looking at the realized CAPM beta plots for General Electric and McDonalds we notice that there appear to be no significant shifts in mean.
This motivates us to propose the application of a statistical test devised by Bai & Perron (1998) to detect multiple shifts in mean occurring at unknown dates in a linear regression model estimated by least squares. While the technique is able to detect an unknown number of shifts, we will begin by pre-specifying the number of shifts to be five. In further work we will apply statistical tests specified by Bai & Perron to detect the number of shifts present in the time series.

The application of the Bai & Perron methodology simply amounts to finding partitions of the data which minimize the sum of squared residuals. The partitions are defined by a set of estimated breakpoints \( \hat{T}_1, \ldots, \hat{T}_5 \) which are obtained by a global minimization of the sum of squared residuals. We specify a pure shift-in-mean model with 5 shifts:

\[
y_t = \mu_j + e_t \quad \text{if} \quad T_{j-1} \leq t \leq T_j - 1
\]

The estimated breakpoints \( \hat{T}_1, \ldots, \hat{T}_5 \) are thus solutions to the following objective function

\[
\min_{T_1, \ldots, T_5} \sum_{i=1}^{5} \sum_{t=T_i}^{T_{i+1}} (y_t - \mu_i)^2
\]

When applied to the Vivendi realized beta we notice that the breakpoint estimates are able to clearly pick out the shifts in mean. Specifically, in the period prior to 12/17/01, Vivendi’s average beta is 0.46. In the period between 12/17/01 and 7/25/03, Vivendi’s average beta rises sharply to 1.2. Again we note that this period coincides with a period of intense acquisition and diversification of its businesses.
The shift is even more apparent when we apply the estimation to Adelphia’s realized beta (depicted in Figure 20 below). Again, the breakpoint estimates pick out a dramatic shift in Adelphia’s average beta on 4/8/98. Prior to this date, the average beta was calculated to be 0.64. Between 4/8/98 and 9/22/98 however, the average beta rose to 2.1886 before falling again to 0.84 between 9/22/98 and 7/12/00. We also note that there is another dramatic positive shift late in 2000 between August and October. Again these estimated windows coincide with periods of intense acquisition and lavish spending by Adelphia executives.
While these results are preliminary and serve a more exploratory purpose, they are nevertheless encouraging. By monitoring the time variation in measures of risk in conjunction with our set of qualitative factors, we may be better able to detect fraudulent behavior. In addition to computing time varying realized betas we may consider other easily computable measures of risk such as time varying risk premiums (i.e. Sharp ratios) and correlations. Moreover, such measures are likely to contain more information than financial ratios due to their forward looking nature and relatively high frequency.

[Discussion of asset growth and revenue/asset growth and profitability to come]

V. Conclusion: Implications for Liability

This paper has investigated ten publicly traded firms which we identified as having between 1995 and 2005 experienced a substantial financial fraud involving substantial allegations of involvement by senior management, where the result of the fraud was the failure of the firm or significant losses in share value. We identified the
following factors as possible red flags of financial fraud: (1) domination by an individual or small group; (2) massive growth; (3) operational mystery; (4) easy access to capital with poor monitoring or controls; (5) unnecessarily complex corporate structure; (6) unusual or substantial involvement in currying influence with politicians; (7) lavish expenditures; (8) significant run-up in share price in the years before the fraud was discovered, and (9) significant volatility in share price in the period shortly before the fraud’s discovery. Left for further investigation in subsequent drafts are whether significant changes in assets, revenues as a percentage of assets, or net profits during the period prior to the discovery of the fraud may also be considered indicators of dishonest accounting practices.

Are our criteria simple empirical observations or might they be considered legally significant in terms of liability? Can a plaintiff sue an auditor or a board of directors grounding his complaints on our criteria, by asserting that they are sufficient to affirm that a serious risk of collapse existed and therefore that the auditors, the board of directors or any other gatekeeper had to exercise a particular attention to what the managers were doing? In other words, might our criteria be treated as red flags, even though of a very general type? These questions can be reformulated by asking whether a court should infer, ex post, some normative implications from the fact that some or all of the quantitative and qualitative criteria we have set out in this paper were present at the time when the company was apparently sailing with the wind.

Any attempt to formulate a proper answer must deal with at least two significant issues. First, the dangers of judging in hindsight are well-known; a strong factual correlation is needed to assert that certain general criteria can be used as a set of facts
from which a reliable presumption can be drawn. Second, the strength of the factual
correlation depends on the liability regime specifically applicable and thereby on the
burden of proof that has to be satisfied to hold the defendant liable. A series of facts that
could be deemed to constitute red flags in a US Section 11 claim may not be red flags in
a Section 10b-5 action or in a Caremark-type inquiry against the board of directors; a
series of facts that could be deemed to constitute red flags in an Italian action against
auditors may be nothing under an equivalent British action, or vice versa.

We think that the other criteria we have identified might also be treated as risk
factors and therefore, in very general terms, red flags. Risk factors, like all the facts that
can lead to a presumption, work in court as instruments to allocate the cost of producing
evidence. The shift in the burden of proof from the plaintiff to the defendant in
negligence cases, when the plaintiff should simply offer evidence of laxity or inattention,
might be justified in certain cases by the presence of our criteria. It is perfectly clear to
us, by contrast, that our criteria are simply not enough to assert anything more than the
existence of a potentially risky situation that required the gatekeeper to pay some higher
degree of attention. It goes without saying that our criteria are not enough to meet the
requirements posed on a plaintiff who must plead scienter. Out of the auditor liability
context, indeed, our criteria are recurrently mentioned by plaintiffs but disregarded by
Courts, which usually never refer to them in the ratio decidendi. This is hardly surprising.
The reported financial cases in which courts deal with red flags are usually 10b-5 cases,
in which the plaintiff must plead scienter.239

239 “The concept of red flag primarily appears in cases arising under Section 10(b) of the Exchange Act”: In
Apparently Caremark-type derivative actions could offer some space to our criteria, as they are grounded on violation of the duty of care or directors’ violation of the duty to act in good faith; but this is not the case. Indeed under Caremark, absent any storm warning, “only a sustained or systematic failure of the board to exercise oversight - such as an utter failure to attempt to assure that a reasonable information and reporting system exists - will establish the lack of good faith that is a necessary condition to liability.”

Our criteria are not the equivalent of a storm warning. They should influence the way directors organize and manage the reporting system and thus might be used by courts to evaluate the monitoring system. However, it is very difficult for courts to second-guess the effectiveness of the monitoring system and accordingly directors’ decisions on the issue are considered a matter of business judgment.

Our criteria might be nevertheless useful in US Section 11 cases and in other cases outside the US in which liability is based on negligence, where they can at least work as helpful instruments to re-allocate the burden of proof. Needless to say, we are well aware that “what constitutes a red flag is an issue of fact” and “what is ordinary in one context may be sufficiently in another to create a duty of investigation by a ‘prudent man’,” and vice versa. Yet we think that in negligence-based actions concerning gatekeepers like the auditors or the underwriters our criteria can be used by courts to assert that the burden of proof has moved from the plaintiff to the defendant.

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240 Caremark, 698 A.2d at 971.
241 “The level of detail that is appropriate for such an information system is a question of business judgment.”: id., at 970.
242 In Re WorldCom, at 679-680.
Appendix: SAS 99 Red Flags

Incentive or Pressure

1. Excessive pressure on operating management or personnel to meet financial targets (sales and profitability incentive goals) exerted by board of directors of chief executive officers.
2. Significant portions of management’s compensation, represented by bonuses and stock options, being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.
3. Rapid growth or unusual profitability, especially compared to that of other companies in the same industry.
4. Unrealistic profitability or trend level expectations by management in overly optimistic press releases or annual report messages.
5. Recurring negative cash flows from operations or an inability to generate cash flows while reporting earnings and earnings growth.
6. Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.
7. Unrealistic profitability or trend level expectations of investment analysts, institutional investors, significant creditors or other external parties in overly optimistic press releases or annual report messages.
8. Management and/or board directors have personally guaranteed significant debts of the entity.
9. Operating losses making imminent threat of bankruptcy or foreclosure, or hostile takeover.
10. Management and/or board directors holding significant financial interests in the entity.
11. Marginal ability to meet exchange listing requirements or debt repayment.
12. High vulnerability to rapid changes in technology, product obsolescence, or interest rates.
13. High degree of competition or market saturation, accompanied by declining margins.
14. Significant declines in customer demand and increasing business failures in the industry or overall economy.
15. Need to obtain additional debt or equity financing of major research and development or capital expenditures to stay competitive.
16. New accounting, statutory, or regulatory requirements.

Opportunity

16. Formal or informal restrictions on the auditor that inappropriately limit his access to people or information or limit his ability to communicate effectively with the board of directors or the audit committee.
17. Significant related-party transactions not in the ordinary course of business or with related entities are not audited or audited by another firm.
18. Domination of management by a single person or small group in a nonowner-managed business without compensating controls.
19. Ineffective accounting and information systems, including situations involving reportable conditions.
20. Inadequate monitoring of significant internal controls.
21. Ineffective board of directors or audit committee oversight over the financial reporting process and internal control system.
22. High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.
23. Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
24. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
25. High turnover of chief executive officers or board directors.
26. Difficulty in determining the organization or individuals that have controlling interest in the entity.
27. Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
28. A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or not arm’s length transactions.
29. Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.

Attitude or Rationalization

30. Significant, unusual, or highly complex transactions, especially occurring close to year end that pose difficult “substance over form” questions.
31. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work.
32. Known history of violations of securities law, or claims against the entity, its senior management, or board members alleging fraud or violations of securities laws.
33. Ineffective communication, implementation, support, or enforcement of the entity’s values or ethical standards by management or the communication of inappropriate values or ethical standards.
34. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
35. An interest by management employing inappropriate means to minimize reported earnings for tax-motivated reasons.
36. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
37. Management failure to correct known reportable conditions in internal controls in a timely basis.
38. Non financial management’s excessive participation in the selection of accounting principles or the determination of significant estimates.
40. A practice used by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
41. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor’s report.
42. Excessive interest by management in maintaining or increasing the entity’s stock price or earnings trend.