Irwin Ross

SHADY BUSINESS

CONFRONTING CORPORATE CORRUPTION

The Twentieth Century Fund Press

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For my wife, Patricia

FOREWORD

In the 1980s we heard, "greed is good." We were told that greed lubricates the engines of capitalism. Each of us pursuing our own economic interest helps to create a society in which all of us are better off. Better off meaning, in this case, that we have more money, more goods, more of what we want. And all because we said yes to that impulse to want more in the first place. It is an idea almost elegant in its simplicity.

But in the 1990s we have discovered that religious faith in capitalism alone would not make all of us, after all, better off. We have been reminded of the need to set limits on where our pursuit of self-interest might take us. We create rules: zoning regulations, liquor licenses, securities laws, and fiduciary responsibilities. We rely upon a web of limits and obligations designed to control the consequences of unbridled greed.

In other words, we recognize that in reaching for that little extra for ourselves or our companies we benefit from a certain restraint, some of it backed by the threat of sanctions. In this sense we know our limits; we know we are capable of venality and even have a weakness for it. Yet we remain surprised at the frequency with which we give in to this particular temptation. Big companies and small, con men, and billionaires all too often stretch the limits we have set on just how much greed is in fact good.

In the last few years the reporting and literature about American business has featured a wealth of material focused on the evils of greed. Here at the Twentieth Century Fund, fairly early in this national reassessment, we supported an important contribution to the field, John Brooks's *The Takeover Game*. Much earlier the Fund supported an examination of *Corporate Control, Corporate Power* by Edward S. Herman and *Who Owns the Corporation? Management vs. Shareholders* by Edward Jay Epstein.

In this sense, this book by Irwin Ross, a noted journalist, extends a long Twentieth Century Fund tradition of exploration into the central issues raised by interplay of capitalism, democracy, and the public interest. We are pleased to publish this book as the first clothbound volume under the Twentieth Century Fund Press imprint.

Richard C. Leone, *President*
The Twentieth Century Fund
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Chapter 1

The Enigma of Corporate Crime

There is no lack of variety, ingenuity and daring in corporate crime. Anyone who doubts this has only to recall the scandals associated with the names of Michael Milken, Ivan Boesky, Leona Helmsley, Salomon Brothers—or any number of large defense contractors. For example:

- In October 1988, the Sundstrand Corporation of Rockford, Illinois, agreed to plead guilty to four criminal counts and to pay the U.S. Treasury $115 million—by far the largest penalty to be imposed up to that time in a case of defense procurement fraud.

  The fraud had been spectacular in its brazenness. Sundstrand, which manufactures aerospace parts, had persistently submitted unrealistically low bids to secure contracts, then recouped its excess costs by fraudulently allocating them to overhead accounts that the Defense Department paid for separately. In addition, the company took phony tax losses, gave gratuities to procurement officials, and billed the government for millions of dollars in spurious charges that disguised such curious items as saunas, movies, golf expenses, household servants.[1]

- The investment firm of Salomon Brothers, hitherto untouched by the scandals that had roiled Wall Street, shocked the financial world in August 1991 by admitting that it had blatantly violated the rules of government bond auctions. From time to time, Salomon had disguised some of its bids as those of customers to enable the firm to garner more than the 35 percent share of the securities at auction to which all bidders were limited. The purpose of the Treasury rule, of course, was to prevent one or two bidders from cornering the market in an issue and putting the squeeze on other traders. In one instance, it was later discovered, Salomon had gobbled up 61 percent of a new Treasury issue. One revelation followed another after the scandal broke, and in a matter of days the top officials of the firm felt compelled to resign. In May 1992, a chastened, reformed and slimmed-down Salomon agreed to put up $290 million to settle all charges; $190 million were fines and penalties and $100 million represented a fund to pay civil claims.

▲ Early in 1991, Michael Milken, the self-made billionaire who created the "junk bond" craze of the 1980s, began a ten-year prison sentence that followed his guilty plea to six felony counts involving violations of the securities and tax laws. It was an extraordinary end to a flamboyant career and was the final act (the collapse of Milken's firm, Drexel Burnham Lambert, was the penultimate one) in a bizarre scenario that began more modestly with the sudden unmasking of Dennis B. Levine in 1986. Levine was a young, swift-rising mergers and acquisitions specialist at Drexel who earned $12.4 million on the side in illegal securities trades based on inside information, much of it fed to him by a network of tipsters. He shielded his operation for years by dealing through foreign banks, and it was only by sheer chance that he was eventually exposed. When the case broke, the size of Levine's loot made him the biggest insider trader to be caught by the Securities and Exchange Commission. But he was only the first. Rather than fight the charges, Levine cooperated with the authorities to mitigate his sentence (he received a two-year prison term) and named a number of coconspirators.

The most startling was Ivan Boesky, the best-known arbitrageur on Wall Street, a man who had built an awesome reputation for shrewdness, daring and great tactical skill. Boesky's entire business was arbitrage; he had a huge following of institutional and wealthy individual investors who funded him with $500 million in speculative capital. Now Boesky's genius was suddenly revealed to involve little more than the deft exploitation of inside information.

The penalty he paid became the biggest for insider trading or other securities fraud up to that date—$100 million, half of which was a fine and the other half a fund against which defrauded investors could make claims. Boesky also cooperated with the government (receiving a relatively modest three-year prison term), and among the names he offered up were Milken and Martin A. Siegel, formerly of Kidder, Peabody and recently of Drexel Burnham Lambert.

Siegel was a star and a golden boy, a whiz at mergers and acquisitions who had been one of the top performers at Kidder. He was also, it soon became clear, a brilliant manipulator of inside information whose transgressions had benefited both Kidder and himself. He pled guilty, parted with $9 million to settle with the SEC, and while awaiting sentencing followed Levine's and Boesky's examples in naming names. He finally received a sentence of only two months in prison. Milken, a much bigger catch who did not cooperate with the government until after his sentencing, was treated more severely than almost anyone anticipated.[2]

- ▲ In August 1988, the Hertz Rent a Car company, the country's largest, pled guilty to charges of defrauding customers by inflating repair bills. Hertz paid a $6.85 million fine—touted as the largest ever in a consumer fraud case—and established a $13.7 million fund for restitution to victimized customers or their insurance companies. The scam was shameless: in some cases, Hertz charged for repair work that had not even been performed, producing counterfeit invoices. Some 110,000 customers (or their insurers) were out of pocket. Had a disaffected employee in Hertz's Boston office not blown the whistle, the fraud might still be going on.[3]

- ▲ From 1978 through 1986, three enterprising New Yorkers enriched themselves through an ingenious tax-dodging scheme in Manhattan's garment center. The trio set up more than thirty-six shell corporations that did no business apart from selling phony invoices to companies seeking to reduce their tax liabilities. These companies would pay the invoices by check and receive back, in cash, 85 to 95 percent of their remittances, the difference being

> the invoice sellers' commissions. The invoice purchasers entered the full value of the checks on their books as expense items, thereby reducing their profits and hence their tax bills. Over the years, according to the government, more than $136 million in phony invoices had been sold to some two hundred companies. The invoice sellers were convicted and sentenced to prison terms ranging from four months to three years.[4]

The foregoing are typical recent examples of corporate crime—defined as crime that benefits the corporation, whose purpose is to enhance corporate profits. This book is not concerned with the sort of crime that victimizes the corporation (such as employee theft, self-dealing, embezzlement). Anyone reading the financial pages knows that corporate crime as here defined is frequently dramatic and sometimes startling in its audacity and arrogance. It is also a perplexing phenomenon, for the offenders include some of the most prominent and respected corporations in the land, and the employees who do the actual dirty work are usually otherwise upright, law-abiding citizens. They have nothing in common with embezzlers or professional con men who move from town to town and from scam to scam, constituting a demimonde as remote from the life of the average businessperson as the Mafia types who run shakedown rackets or traffic in drugs.

But not at all remote from the workaday world of industry and commerce are businessmen who engage in price-fixing or bid rigging, salesmen who pay kickbacks to purchasing agents, defense contractors who inflate bills submitted to the Pentagon, or small merchants who "skim" money from cash registers to cheat the tax collector, not to speak of middle managers at a leading auto manufacturer who a few years ago ordered that odometers on used cars be turned back before the cars were sold as new. None of these people think of themselves as criminals, for they tend to view their illegal acts as victimless crimes from which they do not personally benefit (except insofar as a good job performance may ultimately bring its rewards). Nor, indeed, are these individuals criminals in the sense of being devoted to a life of crime on a full-time basis. Their criminality is intermittent and strictly an adjunct to their legitimate pursuits. If caught, they tend to view themselves as victims of an inequitable system.

Corporate crime is hardly new. Yet, despite the headlines, the phenomenon tends to be minimized in any catalog of social ills. In part this is because more traditional forms of crime—street crime, racketeering, drug trafficking—pose far more serious threats. Moreover, corporate corruption is mistakenly regarded as an aberration, the result of a "bad apple" or two in the corporate barrel, rather than a frequent occurrence in some companies and some types of economic activity. Criminal behavior is not an inevitable feature of corporate life, but it is certainly a standing temptation to which companies often succumb. In the case of price-fixing, Adam Smith took a more mordant view in a famous passage in *The Wealth of Nations*: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[5]

Corporate corruption thrives because efforts to repress it are ineffective and sporadic. It receives inadequate attention from law enforcement agencies, whose resources are always stretched thin, and it is often viewed with indifference by top corporate management until a scandal focuses attention. Frequently, it is only after a corporation is hit by a large criminal antitrust action that top management starts a compliance program to educate middle management. To be sure, one or another aspect of corporate crime periodically becomes the target of a well-publicized cleanup campaign. Insider trading became such a target on the part of the SEC and the U.S. attorney in Manhattan, starting in the middle 1980s. During the 1970s, foreign bribery and illegal political contributions by corporations received great attention, having come to light by chance in the wake of the Watergate investigation. But overall enforcement of the relevant laws is always spotty.

Corporate crime deserves far more attention, if only because of the economic toll that it exacts. Gaining significant business advantage through bribery or price-fixing at the very least diminishes economic efficiency and, at worst, may destroy it in particular sectors. Beyond that, business corruption, like political corruption, can have a demoralizing impact on organizations in which it is rife, not to speak of the community at large, promoting a sense that only the tricksters and cheats win the big prizes.

For its immediate victims, corporate crime imposes sizable costs, which can often be quantified. The whole purpose of price-fixing, for example, is to exact a higher price from customers than would be set by competition. The precise amount of that differential is argued in a class action lawsuit (following a criminal conviction), in which the victimized customers try to recoup their losses and to claim the triple damages that the law allows. Frequently, the suit is settled before trial, and the compromise sum can be taken as a rough (probably conservative) guide to the economic burden of the price-fixing scheme. In 1983, for example, a lengthy lawsuit in the celebrated corrugated box case was finally settled with the plaintiffs receiving $550 million; the largest consumer among the plaintiffs got $15 million. Hardly trifling sums, and that case was but one of many.

To take another field, the economic burden of kickbacks can often be gauged by the sums of money the seller passes to the purchasing agent, for the bribes are generally tacked on to the sales price. (It is possible, of course, that a kickback can come out of a seller's profit, but this is less common.) In imposing sentence in a kickback case, the judge on occasion orders restitution to the victimized company of the money its buyer received.

In insider trading cases, the profit earned by the illegal trader would otherwise accrue to shareholders not in possession of the inside information. There is a finite amount of profit (or loss) between any two prices at which a security trades. If part of that profit is appropriated by someone acting on inside information, it is obviously lost to others who trade the stock. That forgone profit is the economic cost of the offense—a cost sustained by those cheated. In the Boesky case, the $50 million fund to make victims whole is some measure of the magnitude of his thefts.

In tax evasion cases, the U.S. Treasury obviously bears the cost—the amount of unpaid taxes. In the invoice-selling case mentioned earlier, the government calculated that the total value of the invoices came to more than $136 million. To determine the IRS's loss, one would need to know the marginal tax rates of all the companies that participated in the scam. Assuming it was 20 percent on average, the Treasury lost $27.2 million.

How widespread is corporate crime? The answer depends partly on how the term is defined—what offenses are included; and partly on the statistical measures—does one count only convictions or civil court judgments as well, and perhaps even the rulings of administrative tribunals? Are allegations statistically meaningful? There is no agreement on these matters. The first of the few academic inquiries in this field, *White Collar Crime*, published in 1949 by the eminent sociologist Edwin

H. Sutherland, uses the term white-collar crime as a synonym for corporate crime, defining it "as a crime committed by a person of respectability and high social status in the course of his occupation." The last phrase is the operative one, for Sutherland excludes "many crimes of the upper class, such as most cases of murder, intoxication, or adultery since these are not a part of the occupational procedures."[6] Moreover, Sutherland clearly meant his term to apply only to crimes committed on behalf of the corporation, as is apparent from the list of offenses covered, among them restraint of trade, misrepresentation in advertising, copyright and patent infringement, unfair labor practices as determined by the National Labor Relations Board, financial fraud, violations of war regulations.

The heart of the book is an analysis of the records of seventy large nonfinancial corporations, culled from two lists of two hundred of the largest such corporations published in 1929 and 1938. Sutherland's researches covered the life span (averaging forty-five years) of each of his corporations, none of which did he name in the edition published in his lifetime. A corporation is cited as an offender as a result of any adverse decision, civil or criminal, by a court or an administrative commission.

On the basis of these criteria, the score was 980 adverse decisions for Sutherland's 70 corporations, with 14 the average per corporation and 50 the maximum—over the lifetime of any one corporation. The seriousness of the offenses varied greatly, with 60 corporations cited for restraint of trade, 53 for copyright, patent, or trademark infringement, 44 for unfair labor practices, 28 for advertising misrepresentation, 26 for illegal rebates, and 43 for miscellaneous delinquencies.[7]

In their 1980 book, *Corporate Crime*, Marshall B. Clinard and Peter C. Yeager defined their subject as "any act committed by corporations that is punished by the state, regardless of whether it is punished under administrative, civil or criminal law."[8] It was in essence the same definition as Sutherland's, but it covered many more federal agencies—twenty-five of them, ranging from the Agriculture Marketing Service to the Consumer Product Safety Commission to the Labor Deparment's wage and hour division, as well as the criminal, tax, and antitrust divisions of the Department of Justice. More agencies existed than in Sutherland's time, naturally.

The corporate universe surveyed consisted of 477 of the nation's largest publicly owned corporations as well as 105 of the biggest companies in the wholesale, retail, and service fields; the period covered was

1975 and 1976.[9] With a grant from the Law Enforcement Assistance Administration, Clinard supervised a team of researchers who spent two years compiling the enforcement record of the 582 corporations. These data provide the statistical core of the book.

Clinard and Yeager found a good deal of crime, as they defined it and as measured by allegations. For the two years covered, 350 corporations (60 percent) had actions initiated against them—a total of 1,553 cases, an average of 4.4 per accused company—while 232 companies faced no charges whatsoever. Of the 477 manufacturing companies in the study, 71 were charged with multiple environmental offenses, 61 with multiple "manufacturing" offenses (by which the authors meant such matters as violations of the regulations of the Consumer Product Safety Commission), 8 with multiple "financial" violations (such as bribery and illegal political contributions), 6 with multiple unfair trade practices. A relatively small number of manufacturing corporations—a mere 32—confronted 52 percent of the charges.[10]

All these figures, it is important to emphasize, refer solely to accusations, which obviously makes them an uncertain guide to the incidence of corporate crime. The authors' defense is that these statistics are similar to arrest records, which are used as one measure of more traditional crimes. The authors do provide statistics on sanctions—1,529 imposed on manufacturing companies in the two-year period—but because of delays in the enforcement process not all sanctions relate to actions initiated during the same period; no correlation of the two sets of figures is provided.[11] Moreover, some of these sanctions may have been reversed on appeal after the period ended. The earlier study by Sutherland did not have this drawback, for it covered decades in the life of each company and dealt only with adverse decisions and penalties.

Both the Sutherland and Clinard-Yeager volumes are useful in sketching what might be regarded as the furthest statistical reaches of corporate crime, but they cannot be used for comparative purposes because they include different categories of crime. They also suffer from the very breadth of their coverage. Offenses of greatly varying seriousness are grouped together. Thus, in the Clinard-Yeager category of unfair trade practices the authors include not only price-fixing and bid rigging but also false and misleading advertising and illegal mergers. Misleading advertising is a minor matter compared to price-fixing, and