Introduction.

Unwarranted collapses is taken to mean companies who failed, not because their market faded or they did not maintain competitiveness but rather companies which engaged in some practise which caused them to fail. Further, it is suggested that the failures in the decision making process can be explained in terms of the Fraud Triangle Model (see page 6). The corporate collapses listed as case studies in part 2 will endeavour to support this position. They have been chosen for their historical, economic, and legal significance. Therefore this paper, whilst it is about legal issues, is primarily sociological in nature. It is about examining the social factors which go into mismanagement in order to aid in developing a working model to combat them.

This paper will seek to provide the rationale behind the empirical observation that punitive measures and regulation are ineffective controls on companies. That self regulation is the rational way to control companies. This will then set the grounds for propounding model of self regulation where there is a strong incentive towards self-regulation on the part of directors. That is that they are accountable to empowered stakeholders.

The paper is divided into three parts. Part one provides the definitions of the various components of the hypothesis which this chapter is testing. Firstly it sets out a definition of mismanagement which this thesis posits is the specific ill which corporate governance is meant to resolve. Then it sets out the fraud triangle model which forms the centre piece of the hypothesis that poor decisions made by directors result from too much freedom and inappropriate incentives being given to directors.. It then goes on to set out the other theoretical components which expands the fraud triangle models scope from being limited to explaining criminal fraud. These include the application of the groupthink model to explain decisions made by the directors acting as a board. The significance of separate legal personality when coupled with the phenomenon of managerialism, which will be explained in more detail later, in giving directors almost unfettered control of the company is then examined. Finally the contributing effect of a bull market in fuelling poor decision making is examined.

Part two of the paper then examines a series of case studies intended to test the veracity of the hypothesis that the expanded Fraud Triangle model developed in Part one is capable of explaining the reasons and causes behind the corporate collapses seen during the current crisis. The cases have been chosen for their significance in terms of the scale of the collapse and of the effect they have had upon the law.

Part three of the chapter examines the evidence provided in support of the expanded Fraud Triangle model.

Part 1- Definitions: Mismanagement, the Fraud Triangle and Bull Markets.

Mismanagement: the ill of Corporate Governance.

There are different conceptions of what constitutes corporate governance. A partial legislative definition of corporate governance, for issuers of securities only, may be found in s.1269(2)(a-e) of the UK Companies Act 2006 which amends the UK Financial Services and Markets Act 2000. The section states:

(2) “Corporate governance”, in relation to an issuer, includes—

(a) the nature, constitution or functions of the organs of the issuer;

(b) the manner in which organs of the issuer conduct themselves;

(c) the requirements imposed on organs of the issuer;

(d) the relationship between the different organs of the issuer;

(e) the relationship between the organs of the issuer and the members of the issuer or holders of the issuer’s securities.

The above legislative definition is fairly narrowly drawn in that it applies solely to issuers of financial securities and not to all companies, although the arguments put forward in chapter 1 suggests that there are ways that s.89o(2) could have a wider application. Further there is no mention of any wider stakeholder participation, though s.172 of the Companies Act incorporates 'enlightened shareholder value' into the duties of directors. Primarily it is a functional definition, it describes the aspects of a company which fall within the purview of and can be summed up as the following principle: corporate governance refers to the structures and behaviour of a company.

A more theoretical definition is that corporate governance is 'the system by which companies are directed and controlled'.[1] The question then is how ought companies to be run? There are two answers to this, they ought to be run well or they ought not to be run badly. It is the latter answer which this thesis will address.

To define what running a company well means we need to address the question of whom does a company serve? Depending upon the theory which is referenced a company either exists solely for the benefit of its shareholders and should only serve their interests[2] or it must also include wider social responsibilities specifically the interests of other 'stakeholders'.[3] This thesis tends firmly towards the stakeholder theorem. There are variations of that theorem such as 'enlightened shareholder value'.[4] For the purposes of this thesis the particular variations of stakeholder theorem are not considered to be particularly important, the vital issue is the recognition of the company as a social institution which is responsible for the social impact of its actions.

This paper is Utilitarian in nature, in that it is based on the Greatest Happiness Principle.[5] The thesis wishes to address ways to mitigate the harm done to societies when companies collapse for otherwise avoidable reasons; that is because they have done or failed to do something. This thesis is therefore attempting to minimise the social harm done by corporate collapses by trying to prevent them. Thus it falls under the second head of Utilitarianism reducing unhappiness rather than promoting happiness.[6] When companies collapse value is destroyed, therefore wealth is destroyed. Wealth is a measurement of value and a useful mechanism for achieving ends. Achieved ends equate to happiness and that is a

matter of social utility.

Therefore the ill which this theory addresses is the mismanagement of companies; which may be fraudulent or negligent. The case studies listed in part 2 will draw from both sorts of mismanagement. Mismanagement is behaviour by directors, the board generally or the company as a whole which is detrimental to the company and may threaten its continued existence.

There are circumstances where the dissolution of a company is unavoidable and necessary, because the company is inefficient, because the product they produce is no longer required or simply because the company has achieved the purpose it was created for. This thesis is not aimed at such instances, it is aimed at the cases where some mistake on the part of the company led to its end. There are also cases where the company simply collapsed through no fault of its own and there was nothing that could have been done to prevent this. Again this thesis is not aimed at such occasions, though they are likely to be rare given that part of good business is to manage the risks involved.

Further this thesis is not based on the notion that punishment is an effective deterrence As Becker notes, actual detection and punishment of wrongdoings is not in point of fact an optimal usage of resources, the idea should be to provide a workable disincentive to the act.[7] This is especially interesting in terms of fraud, most fraudsters have no prior convictions.[8] According to the Fraud Triangle model this is because the rationale for fraud is not desire but a perceived need.[9] It is also worth noting that there are schools of thought which point out that the apprehension of the probability of detection rather than level of punishment provides the disincentive.[10]

As people do not simply just behave badly, the fault must lie somewhere in the decision making process, either that the wrong decision is made or that the right decision is not made. Therefore in order to explain mismanagement we will look at the decision making processes. To do that we need a model to explain how decisions which lead to

mismanagement are made.

Theory of the Fraud Triangle: the causes of mismanagement.

The Fraud Triangle was developed by D Cressey in *'Other People's Money: A Study in the Social Psychology of Embezzlement'*.[11] *The original theory analysed the psychological factors which led employees to commit fraud or as Cressey described it 'the violation financial trust'*.[12] This thesis will attempt to expand the scale of the Fraud Triangle model to include a wider scope of motivations, namely hubris and negligence. The model is typically visually represented as a triangle (see the diagram below).[13]

The Fraud Triangle theory has developed over the years and informed professional accounting standards.[14] SAS No.99 s.07, passed in response tin late 2002, also broadens the definition of the Fraud Triangle from merely employee fraud to also include the management practises of the company.[15]

The first element of the Fraud Triangle is pressure or incentive. This is defined as a perceived non-shareable financial need, typically involving some element of personal status.[16] The need is subjective in nature and is dependent upon the circumstances and psychology of the individual. In most cases the need that the fraudster feels is based on personal status, either the hunger to achieve it or the fear of losing it.[17] Financial need in this context should not be taken to mean just money. For the purposes of this thesis it means any personal social advancement. The fraudster is allowing personal ambition to overcome their reason; they risk themselves by the fraud, and fail in their commitment to the trust placed in them.

The second element of the Fraud Triangle is opportunity. The perceived opportunity is a means, a mechanism or position, by which the potential fraudster can utilise his or her position to resolve their non-shareable financial need.[18] The perceived opportunity must be deemed a low personal risk, which means that they believe that the wrongdoing will

remain secret.[19] After all, if the point of fraud is personal enrichment, or higher social status, these will not be achieved if the fraud is discovered.

The final element of the Fraud Triangle is rationalisation of the act. According the studies conducted by Cressey most people who commit fraud have no prior criminal convictions and do not view themselves as criminal, but, rather as victims of circumstances.[20] As there is no standard background for fraudsters the model can apply equally well to anyone from managers to employees, indeed the majority of the cases Cressey studied involved either of these as he was reviewing embezzlement. This means they must find some way in which they can rationalise their actions to themselves so that they are not criminals in their own minds, or as Cressey termed it 'the violators' vocabularies of adjustment.'[21]

As this chapter progresses it will attempt to demonstrate that the Fraud Triangle model can explain not just individual behaviour but also corporate cultures and the decision making processes of directors. This thesis is not the first to attempt to demonstrate such a link between company organisation and the Fraud Triangle model. This work expands on the guidelines issued to US auditors by SAS No.99[22] from occupational fraud to organisational fraud, much as this paper does.[23] The article on 'Management Control' developed the point by noting:

How fraud occurs within organizations can be understood by examining the elements that comprise such actions. At an individual level, SAS No. 99 (Consideration of Fraud in a Financial Statement Audit) issued by the Auditing Standards Board indicates that the occupational fraud triangle comprises three conditions that are generally present when a fraud occurs. These conditions include an incentive or pressure that provides a reason to commit fraud (personal financial problems or unrealistic performance goals), an opportunity for fraud to be perpetrated (weaknesses in the internal controls), and an attitude that enables the individual to rationalize the fraud. While the fraud triangle focuses on individual-level constructs of fraud, such as localized instances of cash or other asset appropriation by employees, the Enron example highlights fraud at the organizational level – systemic organization-wide fraud and corruption. At the organizational level, leadership, organizational culture and management control systems form the three points of the

organizational fraud triangle shown below[24]

The ideas set out in the above extract and diagram directly relate to the notions developed by this thesis. However they are describing how organisational fraud arises from a business point of view not from a legal perspective. Nor does it adequately explain how the leadership, management controls and culture become derailed. For these answers we must look back to original Fraud Triangle model and augment it.

The link between the Fraud Triangle; an explanation of individual fraudulent behaviour, and the wrongful acts of entire companies, can be explained by reference to three theories: the doctrine of managerialism, corporate legal personality and the 'groupthink' (see below…) model of decision making.

Expanding the Fraud Triangle

For the purposes of this thesis there are two primary limitations to the model proposed by Donald Cressey, firstly it is limited in scope to explaining criminal fraud and second it does not directly explain groups engaging in fraudulent, imprudent, irrational or negligent behaviour.

The scope of negligence in UK law has been codified by the Fraud Act 2006 with a single unified offence of fraud under s.1(2)(a-c) which cover fraud, in order, by false representation, by failing to disclose information and by abuse of position. As far as it applies to directors the relevant sections of the act are s.4 fraud by abuse of position and s.12 liability of company officers for offences in relation to s.1 by the company.

In all three sections defining fraud the element of mens rea is that the defendant must have acted 'dishonestly'[25] in order to achieve personal gain or to cause, or expose, another to

loss.[26] In the context of UK criminal law dishonesty is established via a two part hybrid test per *R v Ghosh*[27] which requires that it must be established whether an ordinary reasonable person would have considered the act in question dishonest and if so did the defendant realise their action would be deemed dishonest by ordinary reasonable people.

The scope of dishonesty will apply to circumstances where a director or directors knowingly act in such a way as to personally enrich themselves at the expense of the company, such as in the cases of Robert Maxwell[28] and Bernard Madoff.[29] However it will not suffice where the behaviour in question was not intended to directly benefit the wrongdoers, such as in the cases of Sir Fred Goodwin or Richard Fuld, but still ultimately caused harm to the company they worked for. The issue of personal gain is troublesome as the scope of the criminal offence is limited to either direct personal gain or potential or actual loss of another. Whilst it is possible, in theory, to use the provisions of the Fraud Act 2006 to catch dishonest directors by holding that they have put the company, as a legal person, at risk of loss by abuse of their position,[30] this will only apply where there was an actual dishonest intent. It does not factor in issues of recklessness or negligence which may directly lead to the company collapsing. So long as the Fraud Triangle model is limited solely to fraud and hence to criminal law it will not adequately explain the full range of corporate collapses.

To overcome this problem we need to re-examine the Fraud Triangle model itself, the model explains the thought processes which lead an individual to commit fraud. Specifically it is: *A Study in the Social Psychology of Embezzlement.*[31] Embezzlement is the misappropriation of money belonging to an employer by an employee and as such is a form of theft rather than fraud.[32] Fraud has wider connotations, beyond the realms of the criminal law definition of fraud there also exists fraudulent misrepresentation, the tort of deceit, which covers statements which are made recklessly, dishonestly or without belief as to their truth and are likely to be relied upon.[33] Where it can be shown that there has been a fraudulent statement the motives of the person making the statement are irrelevant.[34] Which widens the context of fraud to fit the more problematic cases earlier described by increasing the definition of fraud to include negligence and recklessness. However it is limited to statements and may not cover all occasions where directors act recklessly, dishonestly or negligently.

We must therefore conclude that the Fraud Triangle model, as an explanation of the psychology of misconduct should not simply be limited to cases of fraud as defined by the law. Just because an individual is subject to the effects described by the Fraud Triangle Model, need, opportunity and the ability to rationalise the decision, it does not follow that they will commit the criminal offence of fraud or make dishonest statements some other factor may intervene or they may resist the urge or it may be they can commit a less than honest act which is not technically dishonest. Although it could still be deemed reckless The key issue is that the model describes the reasons and circumstances which make fraud likely. We may hypothesise that the same factors may lead a given director to do an unwise and perhaps dishonest thing without intending to directly gain from it in a criminal sense. This thesis will also, therefore, posit that the same factors which give rise to fraud may also incite a director or directors to seek to benefit themselves in a way which whilst legal is not in the best interests of the company they serve. The logic of this is that when presented with an opportunity to profit in a manner which they think it not technically illegal, even though it is suspect, the same psychological factors which the fraud triangle details will cause a director to be likely to take that option.

The Fraud Triangle and Directors Duties

A final factor must be considered which is that directors owe fiduciary duties to the company as trustees.[35] Whilst technically speaking breach of duty does not amount to fraud per se there are overlaps between the two. Fraud is an act which is meant to dishonestly enrich the fraudster or disadvantage another whilst breach of duty is any act which violates the obligations owed by the trustee to the beneficiaries.[36] Given that equity looks as done what ought to be done it follows that a lack of honest probity, by acting recklessly or negligently for example, will be frowned upon as heavily as actual dishonesty especially as actual dishonesty has been shown to be unnecessary.[37] The key element is that in both cases the parties are acting in a manner which is not in good faith and causes detriment to another.

With regards to the duties of directors they are obligated to act in good faith to further the best interests of the company per s.172 of the Companies Act 2006. It follows from this that

where the directors act negligently, recklessly or fraudulently whilst under the influence of the Fraud Triangle model they will be in breach of their duties. As a breach of duty can be seen, potentially, as akin to fraud then when they act recklessly or negligently in the discharge of their duties then the model would, by extension, also apply in theory. However this is only a hypothesis which this chapter will endeavour to test, although the limits of this thesis means that only inference and anecdotal evidence may be used, further testing using expert psychological and sociology studies will be necessary.

Having examined how the Fraud Triangle model may, potentially, be widened in the case of directors to include recklessness and negligence and not just dishonesty we will now examine the other elements necessary to expand the Fraud Triangle model to adequately explain unwarranted corporate collapses.

Managerialism

Developed by A Berle and G Means, managerialism is the trend, especially prevalent amongst large US and UK public companies, for ownership and control of the company to become disassociated based upon the frequently disparate nature of share ownership.[38] This disassociation will, in the case of the majority of large public companies, leave directors with near total autonomy.[39] This problem is exacerbated by the trend to grant control over the company to the directors in the name of business efficacy.[40] The main limit to the control of directors is the power of the owners to dismiss the directors, a power which the shareholders are forestalled from using as no one person has enough voting rights to force the issue when ownership is disparate.

Corporate Legal Personality

The legal principle of corporate personality holds that at law a company is a legal person with the full legal capacities of a person. This means that when the directors of a company, as the guiding will of the company, decide then it is the company which acts and the directors are not personally liable for these actions.[41] Leaving aside any metaphysical

peculiarities of this theory the practical result is that the company does what the directors will and the directors are not, in general, accountable personally for the actions of the company. The company becomes an unaccountable extension of the director when corporate personality is couple with managerialism. In terms of the Fraud Triangle this will provide both opportunity and the ability to rationalise their decisions.

Groupthink

Groupthink refers to the theory of Irving Janis that aims to explain the psychology underpinning faulty decisions made by groups. Groupthink is "a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' striving for unanimity overrides their motivation to realistically appraise alternative courses of action."[42]

This mode of thinking means that the individual surrenders their personal judgement for safety of a group judgement and this can engender a deterioration of "mental efficiency, reality testing and moral judgement."[43] Where the group is led by a dominant personality or personalities who define the orthodox agenda of the group the act of discussion will tend to lead to group polarisation, which is that discussion enhances the dominant perspective.[44] There is a second issue to be considered with regards to groupthink and that is how the agenda is framed, it is not just the compliance of the group it is also how the choice is presented to them. If the choice is presented in terms of loss, i.e. certain loss versus potentially higher loss, then the group will tend to prefer to take the risk.[45]

Such decision making processes are of concern to the corporate governance scholar as they will surrender rational appraisal for unanimity. Based on this sort of decision making process it is easy to see how an individual or small group can taint the decision making processes of a much larger organisation. The culture of the group provides for willing subservience to the will of others. Within the context of corporate decision making processes the board can easily slip into the pattern of groupthink when there is a strong personality involved or sufficient remuneration is provided that it lulls them into a sense of

compliance. Similarly shareholders may also be brought into a mentality of compliance by sufficient promises and rewards coupled with the potential reduction of remuneration for failure.

The autonomy and powers enjoyed by directors coupled with the wrong group mentality, of directors' means that should one or more fall prey to the mental states described by the Fraud Triangle model; they are potentially in a position to divert the entire company to their own wrongful ends. Therefore it is reasonable to apply the model to companies as a whole and not just to individuals.

Some may well ask the question: what happens if there is no actual fraud in terms of embezzlement?[46] Leaving aside that the definition of fraud can be couched in much broader terms this thesis does not propose that the Fraud Triangle can only be deployed so narrowly. Rather the behaviour, mental states and decision making processes which the Fraud Triangle maps out can as easily lead to corporations behaving in a manner which is either imprudent or quasi-fraudulent. The term quasi-fraudulent is used here to define the behaviour of directors and corporations which may not be strictly wrongful in legal terms, but is still lacking in probity. It also stands to distinguish between honest mistakes and reckless stupidity and greed.

It is worth noting that the general theory described by the Fraud Triangle model is not exclusively restricted to criminology, it is also social and economic in nature too. Fraudsters in economic terms are 'risk preferers', whose perceived benefits outweigh their perceived costs.[47] The perceived cost in this case is predicated on their calculations of the probability of being caught and not the degree of punishment that they will receive.[48] This economic account dovetails with the Fraud Triangle model we are working with.

In conclusion, the hypothesis that this chapter will endeavour to test is that the model described by the Fraud Triangle can explain the mismanagement which leads to the major corporate disasters which corporate governance ought to seek to preclude.

Bull Markets: the contributing context of corporate scandals.

A bull market is a securities or commodities market where the investment price rises at a faster rate than the historical average of the market over a prolonged period,[49] as opposed to a bear market where the price trends downwards.[50]

A common theme to corporate disasters is that they occur during periods when markets are affected by bull market conditions. The bull market conditions are not, however, the cause of the disasters; but the context and the catalyst within which they occur. Therefore it is helpful at this juncture to clearly outline what precisely a bull market is, and what effects it has which are of interest to the corporate governance scholar.

The importance of bull market conditions for the corporate governance scholar are manifold. Firstly, it is indicative of market euphoria which makes it easier to raise money by issuing securities, as there are a plethora of eager purchasers. This can lead to rampant over speculation which results in an economic bubble[51] fuelled by speculation rather than profits. When these bubbles collapse the economic effects are devastating. For example, when the dot-com bubble burst the NASDAQ fell from $6.7 trillion in March 2000 to $1.6 trillion in October 2002, wiping out $5.1 trillion in value. To put this in context the US federal budget for 2002 was $15.8 trillion.[52] This market shift was worth nearly a third of the US Government's annual budget.

Market euphoria means that it becomes impossible to rationally assess market trends. As Coffee noted "in a bubble, extreme optimism for analysts becomes less a heuristic bias than a competitive necessity".[53] This means that when warning signs arise which indicate that there is something remiss, these signs are likely to be ignored, or, when they are taken up, those who do notice these things will be marginalised.[54] This bias is akin to that of 'noise trader' investors, as noted by behavioural finance scholars,[55] investors who follow the 'noise' rather than apply economic reason.

These biases are further exacerbated as the market does not effectively self regulate itself via arbitrage, as the inefficient market hypothesis suggests.[56] This counters the efficient market hypothesis which posited that the share price reflected the actual value of the company.

Therefore there is a lack of control; the bias of professionals and lack of arbitrage, within the market; coupled with ignorance about the market, noise traders in behavioural finance terms. In terms of the Fraud Triangle model there is opportunity and rationalisation; the capacity to raise funds easily without answering awkward questions.

The schemes which caused the collapses examined as case studies in part 2 were often only possible whilst bull market conditions existed. When the markets began to turn, the wrongful behaviour came to light.[57]

A final point of significance regarding bull markets is its effect on directors' remuneration. Certain schemes of payment can, when taken in conjunction with the effects of a bull market, provide a powerful incentive for inappropriate actions. This provides the final element of the Fraud Triangle, the incentive to commit fraud. Therefore we can hypothesise that bull market conditions serve as a macroeconomic trigger to mismanagement.

Support for the above arguments may be found by analysing directors remuneration. When one examines the payment of US directors during the period of 1995 to 2002, a curious pattern emerges. It seems that there is a critical line in terms of directors' remuneration, which, if crossed, will make a director more likely to behave dishonestly in order to preserve his personal wealth and status. The US General Accounting Office (GAO) identified a marked increase in financial restatements, increasing from 92 in 1997 to 225 in 2001, and identified revenue recognition as the most common cause.[58]

This means that from the mid-nineties onwards there was a move by certain directors to

overstate the revenues of their companies. Why did they do this? The Chairman of the US Federal Reserve testified to the US Senate in 2002 that the root cause was the manner in which directors were being remunerated, via stock options packages.[59]

The 1990s saw a change in directors' remuneration, moving by 2001 from direct wages to packages consisting mainly of stock options. The theory behind this trend was it would align directors' interests more closely with those of shareholders by making them shareholders. Repairing the division between ownership by shareholder and control by directors; which Berle and Means had highlighted.[60]

The theory was that remunerating directors via stock options would encourage a more efficient capitalist business model amongst US companies.[61] Unfortunately, instead it created an incentive to engage in share ramping, artificially inflating the share price in the short term, for those directors who held a large number of 'in the money'[62] stock options. This sort of misbehaviour regarding financial statements was made possible by the overvalued equity on securities which results from bull market conditions.[63] In this case the bull market conditions provided not only incentive, but also opportunity as per the Fraud Triangle model.

Directors who are paid primarily in stock options are able to massively increase their own personal worth by arranging for a spike in the stock price. In a case study Efendi, Srivastava and Swanson split 190 companies into two groups based on their statements recorded in the GAO database between 1997 and 2002. Divided into a control group, made up of companies that did not make restatements in that period; and a financial malfeasor group made up of companies who did make a financial restatement on revenues in that period.[64] Directors in the financial malfeasor group held 'in the money' stock options on average worth $22,085,280 (median of $3,928,670) whilst those in the control group held options with values worth $5,167,250 (median of $386,250) on average.[65] Meaning that the directors who made restatements had the incentive of earning more than four times as much as their peers provided that the stock options were 'in the money'. It is no wonder that such directors would misstate their earnings with such a prize at stake.

Interestingly, Coffee notes that those directors in Efendi, Srivastava and Swanson's financial malfeasor group who have stock options in equal to or in excess of their annual salary are 55% more likely to make a restatement.[66] It follows that where there is a statistical correlation between the amount that directors earn and the probability of financial misstatements where the conditions are right and the director is in a position to exercise influence. The model of the Fraud Triangle explains this behaviour in terms of incentive, or economically the perceived reward outweighed the risks for a risk preferring director.[67]

One point which should be made is that amount of money a director may make from stock options is outside of the control of the shareholders and does not need their consent. It seems probable that the capacity to control an income which they do not have to answer embarrassing questions over and which is effectively self justifying will act as a persuasive rationale for corporate misdeeds. The directors can rationalise what they are doing on the grounds they will not get caught as their wrongdoings are concealed and the high stock price means the shareholders have no incentive to investigate.

The final part of the psychology of fraudsters as represented by the Fraud Triangle is the capacity to rationalise what the fraudsters are doing to themselves. Therefore the bull market conditions coupled with the remuneration via stock options provides all three elements of the Fraud Triangle and it is no wonder there was such a spate of corporate scandals in the period between 2000 and 2002.

Part 2 – Case studies of major corporate collapses.

The case studies listed below have been chosen to test the hypothesis that the Fraud Triangle model is capable of explaining why mismanagement occurs. They have been chosen for their historical significance. These cases all had a marked legal, economic and social impact in their times. This demonstrates the real dangers of corporate collapses. These great collapses follow the larger historical economic bubbles as well, in line with the idea that bull market conditions are a macroeconomic trigger to mismanagement. Hereafter please read 'the model' or 'the expanded model' as meaning the expanded Fraud Triangle

Model put forward by this chapter.

2007-2009: The Global Credit Crisis

The wave of defaults which struck the US subprime mortgage sector in 2006-2007 generated a ripple effect in the global banking system that spread out effecting different areas of the world economy.

The collapse of the US subprime mortgage market, which at the time amounted to a fifth of the total US housing market,[68] whilst awful for the US would not in itself have been sufficient to spark the ensuing economic crisis if it was not for the repackaging and resale of the mortgages as securities on the Mortgage Bond Market which effectively clogged up the global financial system with unmanageable debts. Even this might not have had such a pronounced effect if it wasn't for the increased reliance on credit by both consumers and companies which has been steadily on the rise since the 1980s.

These three factors added together provide the recipe for the current financial troubles. An unsustainable housing bubble, over reliance on credit and toxic assets blocking the financial system which provided the credit.

Context: Over reliance on credit

Since the late 1980s consumer credit has grown exponentially, in the UK net consumer lending rose from £484 million in 1992 to £21,064 million in 2002.[69] Whilst in the US the amount of consumer credit rose from $1.1 trillion in 1996[70] to $2.559 trillion in 2008[71] trailing off to $2.47 trillion in late 2009.[72] This increased reliance on credit can be explained in various ways. It may be the result of an increased need based on a failure of wages to stay in line with inflation or alternatively it may represent an increased ability to realise the potential value of their assets. The reason, whilst of crucial interest for social policy is not as salient as the simple fact that this increased credit meant a net increase in

the amount of liquidity in the market. This increased liquidity is reflected in increased consumer spending which companies became reliant upon for profits. Where consumer confidence was rocked or consumer credit was damaged then there would be a knock on effect in spending and hence in corporate earnings.

Concurrently the corporate sector moved away from a policy of retaining profits for reinvestment[73] or to smooth over earning gaps.[74] This meant that without a buffer to support a company through the leaner times the companies would be forced to borrow from the banks in order to smooth over any problems in cash flow. Similarly where a company wished to expand instead of providing part of its own capital to facilitate the expansion it was instead reliant upon syndicated loans from the financial sector which would be a drain against future earnings. Thus forcing the company into a leveraged position wherein they could not divert cash flow to meet immediate needs as that capital was already obligated to meet existing debts. This meant that any sharp shortfalls in earnings would leave companies dangerously exposed to insolvency as there was no safety net of savings to fall back on.

Given the risks which over indebtedness is known to carry one may well wonder why it was that both personal and corporate debt grew so rapidly. The answer to this may be found in the fact that the 1980s marked the start of the longest running bull market in history in the US and by extension in the world economy. With the market ever increasing all future earnings would always trend upwards therefore borrowing against future earnings seemed a rational action as the future earnings would cover the borrowing. All of which presumed that the market would continue to trend upwards. This presumption is perhaps best enshrined in the words of then chancellor Gordon Brown in 2002 to the Transport and General Workers Union ‘we today in our country have economic stability not boom and bust’.[75] There are a number of explanations as to how this presumption arose, George Soros explained this phenomena when discussing the global super-bubble hypothesis by explaining that the presumption was that markets moved towards ‘equilibrium’.[76] This meant that the free market when free from governmental interference would shift towards a stable format which promoted growth and wealth. John Coffee had a more pessimistic but more human explanation with regards to the behaviour of market participants in a bull market scenario noting that they would suspend their disbelief and ignore prior analogous

scenarios when faced with long running economic prosperity.[77] He pointed out that in such circumstances it is not only hard but is in fact 'dangerous to be sane in an insane world'.[78] As chapter 4 of this thesis points out it may not have been so much 'hard' as outright impossible for companies to maintain a rational outlook given the twin forces of excessive rewards offered to directors coupled with the never receding threat of a hostile takeover via the market for control for failing to aggressively grow the company share price.[79]

Whichever explanation we abide by the end result of the worst financial crisis yet in global history indicates that the presumption of a balanced sustainable market was false in this instance.[80] In fact it may be the case that the over exuberance which gave rise to the presumption of the markets long term prospects is what also led to its failure. The essential detail is that the lack of saving and over reliance on credit meant that companies found themselves over leveraged and unable to weather a sharp market shift.

Cause: Sub-Prime Mortgages

A sub-prime mortgage is, as the terminology would suggest, a mortgage offered to a mortgagee who falls below the normal or 'prime' lending criteria. Typically this will be the result of a poor credit history or other factors. In the US the mortgages lent by 2006 out to sub-prime market mortgagees amounted to $1.3 trillion, approximately one fifth of the $6 trillion US mortgage bond market.[81] The sub-prime mortgages being offered in the US had three significant flaws to them. The first is that they were being offered to those who would not have been able to gain a traditional mortgage, which made them inherently more risky as there was an increased likelihood of default. Second a significant proportion of the sub-prime mortgages were sold as interest only loans. These were mortgages where only the interest was paid on the loan for the first one to five years, after which the mortgage would become a standard repayment scheme with significantly higher repayment criteria. Third the adjustable rate mortgages were linked to the national interest rates which meant that any changes in the US interest rates would generate a spike in repayment costs.[82]

From 2001 to 2004 the national interest rates in the US had been kept low by the Federal Reserve in order to avoid the possibility of a recession resulting from the dot-com bubble, with the interest rate averaging at 2.25%.[83] However in 2004 the interest rates began to rise in order to prevent inflation, rising from 2.25% in June of 2004 to the highest point of 6.25% in June of 2006.[84] This caused a spike in repayment costs in the US, a spike which many were simply unable to meet and lead to the wave of defaults now know as the 'sub-prime crisis' throughout 2007.

Based on this analysis it seems inevitable that the US housing market would be subject to a readjustment. The issue then becomes why were people so willing and eager to involve themselves in it, both from the point of view of the consumers, mortgage retailers and the secondary purchasers? The answer for the consumers is that the US housing market had trended up consistently, doubling in value from the third quarter of 2003 to the first quarter of 2006.[85] The incentive then was to buy and watch the equity of the property grow. For the mortgage retailers the issue seems to have been one of quantity of sales over quality of investment. From 2001 at the beginning of the explosive growth in the sub-prime mortgage sector to 2006, when the sector peaked and began its collapse, there was a year on year decrease in the quality of the loans offered by sub-prime mortgage retailers.[86] Such a correlation of increasing numbers of issued sub-prime mortgages versus decreasing quality suggests a widespread malaise amongst the industry. This was likely brought on by the ever increasing demand for sub-prime mortgages by both secondary purchasers and consumers coupled with a reward scheme for mortgage resellers linked to quantity rather than to quality.

The secondary purchasers were those who bought the mortgage bond, that is the financial rights attached to the initial mortgage from the mortgage issuer. Their hunger for high yield returns for their investment led to a massive increase in the securitised share of the sub-prime mortgage market, increasing to 75% by 2006.[87] This yields a net figure of $975 billion in securitised sub-prime debt being traded on the world markets. Why would the secondary mortgage market be so desirous of these bonds? Simply put they were hypothetically secure as they were linked to house prices, and with the house prices trending upwards any default would allow the reclamation of the full sum. They also would

provide steady revenue streams to the investor to then conduct further speculation with. The purchasers of the Mortgage Backed Securities (MBS)[88] were not unaware of the risks involved in purchasing sub-prime mortgages, indeed if they were solely being sold as sub-prime mortgage backed securities it seems likely that they would have taken greater care to manage the risks involved or simply not purchased them all together. This problem was bypassed by reselling the MBS's as Collateralised Debt Obligations or CDO.[89] This briefly maps out what the sub-prime mortgages were, what there attraction was and what the flaws were. Now we need to address how they ended up being spread across the globe by means of 'securitisation'.

Therefore in order to understand the root causes of the crisis we need to understand what is meant by 'securitisation', literally it means to make a thing into a security. What this means in financial terms is less clear. The initial definition of a security being provided by the US Securities Act of 1933 as:

'The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.'[90]

Whilst in the UK securities are defined by s.14 of the Banking Act 2009 as follows:

(1) In this Part "securities" includes anything falling within any of the following classes.

(2) Class 1: shares and stock.

(3) Class 2: debentures, including—

(a) debenture stock,

(b) loan stock,

(c) bonds,

(d) certificates of deposit, and

(e) any other instrument creating or acknowledging a debt.

(4) Class 3: warrants or other instruments that entitle the holder to acquire anything in Class 1 or 2.

(5) Class 4: rights which—

(a) are granted by a deposit-taker, and

(b) form part of the deposit-taker's own funds for the purposes of section 1 of Chapter 2 of Title V of Directive 2006/48/EC (on the taking up and pursuit of the business of credit institutions).

As a definitions these are unhelpful, although the UK definition has the advantage that it is not as open ended as that provided by the US it still provides a list of identified securities and fails to provide a definition of security. However by proceeding analogically we may define a security as any transferable financial interest. Therefore the securitisation of a mortgage is when the rights and interests of a mortgage, or a proportion thereof, which are owed to the mortgagor are sold on to another party. In the case of the mortgage the specific right sold on will be to the payments made by the mortgagee.

This ‘securitisation’ of mortgages allowed for the mortgages to be sold off as bonds to international investors. An additional level of complexity was leant to this arrangement by the dividing the mortgages into different tranches and repackaging of the mortgages amongst different securities where they would be bundled together with tranches from other mortgages to offset each other thus forming a CDO. The CDO would in theory cross link tranches from prime mortgages with those of sub-primes and thus offset the risk. For example a mortgage from the ‘rust belt’ region of Michigan might be bundled together with mortgages from Austin Texas or from Manhattan, traditionally areas of wealth and affluence. This would offset the otherwise risky subprime mortgage, at least in theory. A flaw exists with this theory though. The simple act of separating the mortgagee from the mortgagor by reselling the mortgage on breaks down the fundamental contract at the heart of all mortgages. Although the mortgage is secured *in rem* against the property the loan agreement between the two parties is *in personam*. The value to the mortgage is the interest on the loaned capital which will only be met if the mortgagee is able to meet the repayment schedule. It is that ability to repay which is crucial to the proper valuation of a given mortgage.

Given that this may not be available to the subsequent secondary purchaser, they would be in no position to properly value the asset they had bought, or the risks which came with it. To bridge this gap the Credit Ratings Agencies would independently assess and value these mortgage backed securities, rating them according to their value. However a fundamental discrepancy remained. Due to privacy laws the credit rating analysts did not have access to the personal information of the mortgagees. Lacking such ‘soft information’ they were instead forced to rely on ‘hard data’ regarding property prices. Such ‘hard data’ was flawed, it showed an ever increasing trend in property prices which could not continue forever and would at some stage be corrected by a very painful readjustment. Such a readjustment would automatically threaten the basis of the loaned capital by potentially reducing the value of the charged asset below that of the loan. Furthermore even where information was available to the secondary mortgage purchaser for them to make a personal valuation of the value of the security it may not have been viable to make an informed valuation where the security was in the form of a CDO as the amount of information necessary to value a CDO was simply unmanageable. As Warren Buffet noted:

‘You create a CDO by taking one of the lower tranches of that one and 50 others like it. Now if you’re going to understand that CDO, you’ve got 50-times-300 pages to read, it’s 15,000. If you take one of the lower tranches of the CDO and take 50 of those and create a CDO squared, you’re now up to 750,000 pages to read to understand one security. I mean, it can’t be done. When you start buying tranches of other instruments, nobody knows what the hell they’re doing. It’s ridiculous. And of course, you took a lower tranche of a mortgage-backed security and did 100 of those and thought you were diversifying risk. Hell, they’re all subject to the same thing. I mean, it may be a little different whether they’re in California or Nebraska, but the idea that this is uncorrelated risk and therefore you can take the CDO and call the top 50% of it super-senior – it isn’t super-senior or anything. It’s a bunch of juniors all put together. And the juniors all correlate.’[91]

This indicates two fundamental problems with the resale of the subprime mortgage backed securities. Firstly the valuation of them was based on inadequate data and secondly what data was available may have been misleading. This being the case it seems surprising that they were so readily acceptable to the market, although, given the excellent ratings required from the Credit Ratings Agencies for these securities in order to make them viable it is perhaps unsurprising that buyers would be lulled into a false sense of security. Given the sheer scale, scope and potential unreliability of the data involved it does seem irrational that the Credit Ratings Agencies ever gave these debts good valuations.

Further problems existed with the usage of CDOs, as Warren Buffet noted the different tranches of the CDO correlated together. What this meant was that any shift in the US housing market, such as the bubble bursting, would effect all the tranches rather than some. Therefore there would be no off setting of losses by supposedly superior mortgages which the sub-prime related mortgages were purportedly linked too. Furthermore the nature of the CDO with all the different tranches interlinked and cross referenced too each other meant that it was impossible to divide the different tranches of mortgages from each other. This meant that in order to dispose of the risky parts of the CDO they would have to dispose of the entire security and take a significant loss in the process.

Catalyst: Over dependence on International Money markets

Having established how the sub-prime mortgage backed bonds were flawed and why they were allowed onto the international markets the next question is how could the failure of a housing market in one country, albeit a very powerful one, was able to threaten the financial viability of the world economy so profoundly. After all the entire US sub-prime mortgage was only worth $1.3 trillion, not enough to bankrupt the world economy, which was valued at $57.6 trillion in 2008.[92] The answer to this lies in the way that the banks reacted to the toxic assets on their balance sheets and the knock on effect that this would then have on the global economy. When the sub-prime mortgage bubble burst the international banks found that they had an awful lot of mortgage backed bonds on their balance sheets. Worse because of the nature of these bonds, with the different mortgages packed together as CDO's, they had no way of telling if the assets they held were good or bad. In order to secure themselves against the potential damage to their balance sheets from these toxic the banks moved to retain capital rather than lending it on the international Money Markets[93] as they would otherwise have done. This shortfall in liquidity also meant a resulting downturn in available consumer and business credit as well. These constraints on available credit then had a wider impact on the global economy which had become reliant upon cheap and easy credit.

To understand the reliance on the international money markets it must first be understood that all banks are 'quasi-insolvent'. That is they operate by lending the money which has been deposited with them, the effect of which is that their debts exceed their repayment capacity. For instance where a bank lends out 75% of its total deposited funds the remaining 25% will never be sufficient to cover the repayments if a significant proportion of the depositors decide to withdraw their money, this is the phenomena known as a 'run on the bank'. This problem is exacerbated by the nature of financial investment, the banks lend long and borrow short. This means that the money the banks borrow from their depositors may be recalled at anytime whilst the loans they offer have fixed repayment schedules which prevents a bank recalling its loan in at any stage.[94] Even were a bank to recall its loans prior to the final repayment date, this would lead to an increased risk of default as the recipients of the loan are unlikely to have the funds to hand to cover the full amount: if they had they would not have needed the loan in the first place. In order to plug this gap in their

finances the banks borrow money from the money markets using the assets, eg debts, they have accrued from their lending as collateral. However when money is not available on the money markets then the banks will face difficulty in meeting their financial needs and this may cause a bank already weakened, say by discovering its position has been weakened by toxic assets, to fall.

Being unable to borrow as efficiently on the international money markets further constrained the banks abilities to lend to the private sector. This lack of credit coupled with the general rise in levels of consumer debts this meant that the rate of consumer spending was also curtailed. Which in turn had a knock effect on the wider economy. It was not just consumer credit that was adversely effected by the shortfall in available credit, companies frequently make use of credit facilities offered by banks and where such credit is not available then a company which is overly leveraged may find itself becoming insolvent.

All these factors added together became what is now known as the 'credit crisis' and due to the highly leveraged nature of the modern economy such a shortfall in available credit to smooth over gaps in cash flow, which might otherwise have been made up from retained profits, the effects on the world economy have been devastating.

Effect: Corporate Failures

The history of the 'credit crisis' is replete with tales of various institutions which failed during 2008, Bear Stearns, Lehman Brothers, RBS, HBOS, GM, Landsbanki to name but a few of the most high profile. This section will focus on the collapse of Lehman Brothers in the US and of RBS in the UK, it will also examine the details of the Fraud conducted by Bernard Madoff. The rationale for selecting these three are the significance which Lehman Brothers had and the far reaching effects of its fall, the lessons of the risks of aggressive expansion demonstrated by RBS and the sheer scale of fraud which is possible for a single fund to sustain with regards to the Bernard Madoff fund.

Of the three cases the collapse of Lehman Brothers is the most straightforward resulting as it did from over exposure to bad sub-prime debts. Lehman's was one of the US banks which funnelled the sub-prime CDOs onto the international markets, in 2007 it had underwritten some $85 billion worth of Mortgage Backed Securities making it the largest underwriter of US MBS's.[95] Not only did it maintain its own stock of sub-prime backed CDOs it also sold them on to the international markets. However it was unable to foist off a lot of the higher risk CDOs formed from lower-rated tranches onto the international market thus forcing it to maintain a higher exposure to the sub-prime mortgage bubble. This was coupled with its own exposure as the largest primary investor in sub-prime CDOs left it with a vulnerable balance sheet. With no palatable way of off loading the bad debts and with no access to additional funds from the Money Markets with which to manage the bad debts Lehman's was forced to declare a $2.8 billion loss in the second quarter of 2008.[96] This was coupled with a reduction of 20% in the Lehman's portfolio of MBS's via write downs. However this was insufficient to placate market fears.

On September 15th 2008 Lehman Brothers filed for Chapter 11 Bankruptcy Protection[97] $619 billion in debts and $639 billion in assets.[98] Although Lehman's assets outweighed its liabilities it simply did not have enough capital to meet their immediate cash needs. Nor had they been able to secure any addition funding by finding a partner company to merge with, Korean Development Bank had pulled out of a proposed deal on the 9th September and subsequent potential purchasers, Barclays Bank and Bank of America, declined to purchase Lehman's. It appears that this was largely due to an unwillingness on the part of the Federal Reserve and US Treasury Department to underwrite any proposed takeover.

How did Lehman's once one of the world's premier banks come to such a sorry end? The answer is that Lehman's was the biggest participant in the sub-prime mortgage markets and in the securitisation of mortgages.[99] These dealings allowed Lehman's to post record profits, reaching its highest ever share price in February of 2007 at $86.18 per share.[100] However this exposure to the sub-prime mortgage market meant that when the bubble burst Lehman's was poorly placed to ride out the troubles. When the housing market first began to show troubling signs in mid 2007 Lehman's remained confident that the CDO structures would properly manage the risk, only to discover that they did no such thing. Further

Lehman's had expanded aggressively under CEO Richard Fuld's control borrowing heavily in order to facilitate its expansion so that by 2007 its asset to equity ratio was 31 to 1 meaning it was highly over leveraged with a lot of debt to service from future earnings. When such earnings failed to appear and were instead replaced by losses due to exposure to bad sub-prime debts Lehman's became insolvent.

The effects of Lehman's insolvency had far reaching effects on the financial system sparking as it did a panic on the US money markets. Lehman's had $785 million stake in the US money market when it filed for bankruptcy.[101] In the wake of this default that stake was valued at zero which sparked an exodus of investors from the US money markets . This effectively removed $400 billion in short term credit from the international money markets just when credit was already desperately short.[102]

The tale of Royal Bank of Scotland (RBS) is similar to that of Lehman's in that it too faced a shortfall in financing due to restraints on the free flow of credit on the international money markets. It also incurred a great deal of debt via exposure to the sub-prime mortgage sector and was unable to cope as it had been lead down a path of aggressive expansion by its CEO, Sir Fred Goodwin.

At the start of 2008 RBS was one of the world's largest banks with a balance sheet of £1.9 trillion.[103] The core business itself was worth £75 billion in 2007 making it one of the ten largest banks in the world. [104] However at the start of 2000 RBS was a middle ranker in the UK banking sector with little impact on the global stage, this changed rapidly with the purchase of NatWest by RBS vaulting it into the first rank of the UK banking sector and establishing Sir Freed Goodwin as a respected financial dealmaker.[105] This was followed by a series of high profile purchases across the world; including into the US via the purchase of Citizens bank which increased its exposure to the US sub-prime sector.[106] The spate or purchases conducted by RBS slowed in 2007 in the face of shareholder reservations regarding the long term risk of continued aggressive expansion and the dangers of being over leveraged.[107]

However RBS was unable to resist the opportunity to purchase the Dutch Bank ABN AMRO, forming a consortium with Fortis and Banco Santander to bid for it. It was at this juncture that Sir Fred Goodwin made his greatest blunder. When the 'credit crisis' first hit in mid 2007 he could have elected to pull out of the purchase, instead he went ahead with it and by his own admission paid fifteen to twenty billion pounds too much for it. [108]

Taken together the purchase of ABN AMRO and its exposure to the sub-prime bubble left RBS with a large hole in its finances which the UK government was forced to step in and fill, acquiring 58% of the shares in RBS, subsequently rising to 70%.[109] Effectively RBS, like Halifax Bank of Scotland was part nationalised and its debts guaranteed by the UK. Thus turning its debts into sovereign debts and stabilising the share price.

The final case arising during the 'credit crisis' is that of Bernard L. Madoff Investment Securities LLC. Madoff was convicted in June of 2009 of running the largest 'ponzi scheme' in history and sentenced to 150 years in prison. A 'ponzi scheme' takes its name from Charles Ponzi a convicted fraudster who founded the most well known of such schemes in 1918 in Boston and was subsequently arrested for mail fraud in 1920. A 'ponzi scheme' is essentially a scheme which pays investors with the money provided by subsequent investors.[110] Thus it never makes any actual real profits as per the discussion in chapter 4 regarding real versus financial wealth,[111] and when eventually the scheme fails the latter investors are left with nothing.

Although it would appear at first that the 'ponzi scheme' which Mr Madoff was running was separate from the 'credit crisis' two distinct details would argue against this. Firstly it is that the 'ponzi scheme' which Madoff operated came to light because of the shortfall in potential investors resulting from the downturn in the global economy coupled with withdrawals from existing investors which he simply could not meet.[112] Secondly it came shortly before it was revealed that hedge fund managers frequently misrepresent their funds.[113] Which suggests that Madoff was not an isolated case but instead it demonstrates that the hedge fund industry is open to abuse given the lack of regulation regarding transparency and risk management.

By the time of its collapse Bernard L. Madoff Investment Securities LLC owed approximately $50 billion to its investors. Furthermore it also appears that the fund may not have ever conducted any legitimate business which suggests that the entire business was created to facilitate the fraud.[114]

Applying the Fraud Triangle model to our three case studies reveals some interesting details. First the application of the incentive to our three cases. In the case of Lehman's and CEO Richard Fuld it seems likely that the incentive was pecuniary reward and reputational gain. Having taken charge of Lehman's in 1994 it grew rapidly and aggressively to become the fourth biggest bank in the US thus gaining him fame and fortune. In the case of RBS the story is clearer, Sir Fred Goodwin's reputation amongst the banking elite was based on the successful takeover of NatWest in 2000. It is perhaps not unsurprising that instead of consolidating he pursued other more aggressive deals ending finally with the purchase of ABN AMRO a move some believe was intended to stop rivals at Barclays clinching the biggest European banking merger.[115] It is difficult to understand what else but personal pride could have driven him to continue with the deal in the face of a worsening economic climate. Bernard Madoff's incentive seems to be clear, it was a simple desire to maintain the lucrative lifestyle to which he had become accustomed too.

With regards to opportunity the issue is simple. All three businesses were under the more or less absolute control of their CEOs and therefore would operate as they saw fit. This meant that the opportunity for arrogant mistakes or misappropriation was constant.

The ability to rationalise the decision to commit foolhardy or wrongful acts is straightforward in two of the cases. For both Sir Fred Goodwin and Richard Fuld their actions were justified by the belief that aggressively leveraging their banks would be in the long term benefit of those banks. In other words preference for risk was not only good but essential in their minds. This links back to Coffee's notion that it was vital to follow the trend in exploiting the bull market or otherwise be left behind. With regards to Madoff we can only deduce that he thought he was doing the right thing for himself and for his family by exploiting his investors.

Part 3 – Conclusion.

There are two vital questions which need to be answered here. First, do the arguments and evidence presented here provide a compelling case for accepting that the hypothesis, regarding the explanation of corporate collapses, is a basis for a viable working theory? Secondly, if the hypothesis can form a viable working theory what are the implications of this for the rest of this thesis?

With regards to the first question the answer is a qualified yes. The Fraud Triangle model has been able to provide some clues as to common features which link together how corporate collapses come about. It has been able to provide a possible explanation as to the reasons why companies, or specific individuals within these companies, have engaged in behaviour that was ultimately destructive to the business itself. For now it will hopefully stand as a working test.

However a number of caveats should be added to this assertion. It is based, to a certain degree, on a priori reasoning and on post rationalisation of the events. Evidence for this theory would be stronger if it were possible to engage in corroborative empirical studies.

The second question, prima facie, raises some interesting thoughts. If the Fraud Triangle model provides a coherent explanation of the causes of mismanagement then it will also provide a reasonable test for the extant law meant to address this particular problem. Furthermore, it should also be directly applicable to the theories of corporate governance provided by various writers and by this thesis.

If these laws and theories fail to meet the standard of this test, which is that they fail to address the root causes of corporate mismanagement, does it mean that they are ineffective or that they address the problems of corporate governance in a different manner? If it emerges that the current laws and theories do not directly address mismanagement then there is clearly a place for a theory which does. If it emerges that they not only do not

address this issue but that this means that they will be ineffective; then there is great cause for worry.

The reasoning behind the proposition that punitive or regulatory systems will fail is derived from the Fraud Triangle model. If a corporate governance regime is aimed at detection and/or punishment of those engaged in mismanagement and fraud this operates only against the opportunity aspect of the Fraud Triangle model.

Per the expanded model, the fraudster will be likely to commit the fraud provided that they can rationalise their actions that is that they think they can get away with it. This means that punishment cannot be an effective deterrence to fraud.

Because the fraudster will do what he does because he can rationalise the act, it follows that when they are subject to oversight which prevents this rationalisation they will not commit the act. Therefore, regimes based on detection may well act at least in part as a disincentive to mismanagement, however the problem is that the persons involved are in a position where their actions are hard to question because of the benefits of corporate personality coupled with managerial power. Therefore it is not reasonable to presume that regulations based solely on detection will be an effective model to curb mismanagement.

The final conclusion of this paper is that the derived Fraud Triangle model provides a working definition of the specific behaviours which give rise to mismanagement that corporate governance must attempt to resolve; furthermore, by understanding the behaviour behind mismanagement we can test whether a given law will actually prevent mismanagement or not.

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[51] A bubble is the term used to describe a situation when value is highly leveraged, it has been inflated like a bubble and like a bubble is in reality hollow. Bubbles can arise in markets, sectors and economies. Bubbles can arise simply from market hype and do not need a degree of dishonesty per se. Though it may frequently be there anyway.

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[57] Evidence for this can be found with the example of Bernard Ebbers CEO of Worldcom who's lack of probity was revealed by a downturn in the US telecom market or the fall of the South Sea Company when a lack of liquidity in the market meant they could not raise money to meet their debts. See: T Clarke, *International Corporate Governance: A Comparative Approach* (Routledge 2007, Abingdon UK) Page 337

[58] Report on Financial Statement Restatements, GAO (2002) Page 14

[59] A Greenspan**,** Testimony to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate July 16, 2002.

http://www.federalreserve.gov/BOARDDOCS/hh/2002/july/testimony.htm (accessed 27/12/2009)

[60] A Berle and G Means, *The Modern Corporation and Private Property* (revised edition, Harcourt, Brace & World 1968, New York USA) Pages 78-84

[61] The original idea that a vested interest in the success of the company will result in greater efficiency goes back to the criticisms made by Adam Smith in 1776, who believed that companies could never be as efficient as partnerships as the directors would not take the same 'anxious care' as they would with regards to their own property. See: T Clarke, *International Corporate Governance: A Comparative Approach* (Routledge 2007, Abingdon UK) Page 14

[62] In the money means that the share or option is worth money and so can be sold or exercised for value http://www.investopedia.com/terms/i/inthemoney.asp (accessed 27/12/2009)

[63] Efendi, Srivastava and Swanson , *Why do corporate managers misstate financial statements? The role of option compensation and other factors* Page 1. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=547922 (accessed 27/12/2009)

[64] Ibid Pages16-20.

[65] Ibid Page 21

[66] J Coffee, *Gatekeepers* (OUP 2006, Oxford UK) Page 63

[67] G Becker, 'Crime and Punishment: An Economic Approach' (1965) Journal of Political Economy 76 Page 179

[68] 'The Downturn in Facts and Figures' BBC 21/11/2008

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[69] Consumer credit 1992-2002: Annual Abstract of Statistics

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[73] W Lazonick and M O'Sullivan, 'Maximising Shareholder Value: A New Ideology for Corporate Governance' in T Clarke (ed) *Theories of Corporate Governances* (Routledge 2007, New York) Pages 292-298

[74] J Coffee, *Gatekeepers* (OUP 2006, Oxford UK) Page 59

[75] G Brown, *Manufacturing Matters* (28/03/02)

[76] G Soros, *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What it Means* (Public Affairs Ltd 2008, London UK) Pages 91-93

[77] J Coffee, *Gatekeepers* (OUP 2006, Oxford) Pages 67-69

[78] Ibid Page 69

[79] Chapter 4 Pages 30-33

[80] As an aside a hypothesis which might explain this is that the cycle of boom and bust could only be prevented by having in place systems to counteract the over exuberance of human nature, however such planned economies have their own flaws as well. In fact it seems they both have the same flaw that they do not factor in the irrationality which seems inherent to the human condition. In philosophical terms they do not account for this known but unknowable factor.

[81] 'The Downturn in Facts and Figures' BBC 21/11/2008

http://news.bbc.co.uk/1/hi/business/7073131.stm (accessed 14/10/09)

[82] Ibid

[83]Federal Reserve Bulletin Statistical Supplement September 2008, Page 13

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[84] Ibid

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