

Want to Stop Corporate Fraud? Pay Off Those Whistle-Blowers

By Luigi Zingales

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It would be tempting to dismiss the corporate scandal that has crippled the food giant Parmalat as another Italian quirk, like the Mafia, corrupt politicians and trains that are always late. But the Parmalat scandal, which follows massive corporate irregularities at U.S. companies such as Enron, WorldCom, HealthSouth and Tyco, is merely the most outrageous recent example of a common problem: financial markets plagued by fraud.

Why? Explanations based on the emergence of a "culture of greed" in the U.S. financial markets miss the mark. A better explanation is that, over the past 20 years or so, fraud has become not only easier but also more lucrative. It is easier because the increased complexity of organizations makes it simpler to divert resources. Between 1996 and 2001, the number of foreign subsidiaries of Tyco, for example, grew from 154 to 1,750, making it impossible for all but a handful of people in the company to understand the whole picture. When a company is as opaque as that, hiding transactions from the board of directors is easier.

Fraud has also become more lucrative because of the general increase in market valuations. In 1980 a shameless manager who successfully manufactured \$1 of earnings would have increased the value of his company, on average, by only \$7, based on the S&P 500 price/earnings (P/E) ratio at the time. At the peak of the Internet bubble (when the S&P 500's P/E ratio reached 35), the same fraud would have paid five times as much. Given that the reward for dishonest behavior has increased, I propose a financial reward for honesty. More on that in a moment.

Congress has tried to address increased fraud in two ways: Under Sarbanes-Oxley regulations, the penalties for fraud have increased. The law also includes a series of rules (more independence for the board, better professional qualifications of the directors, etc.) aimed at improving outside monitoring of companies. While bigger penalties certainly help, I am skeptical about the effectiveness of outside monitoring. Enron had on its board highly qualified people, such as Robert K. Jaedicke, professor of accounting and former dean of Stanford Business School. Nevertheless, as we now know, the fraud went undetected. Organizational complexity is now such that it is extremely difficult to uncover fraud without some help from within the company. Consider that even now, after two years and 1 million hours of investigation, the prosecutors in the Enron case need former chief financial officer Andrew Fastow's cooperation to decide whether they can bring charges against former chairman Kenneth Lay and former CEO Jeffrey Skilling.

Eliciting more information from insiders would seem to be the obvious solution. And yet employees generally cooperate only after the fact, when they talk to avoid personal charges; their cooperation is rare before charges are brought. HealthSouth and Parmalat may have manipulated accounts for more than a decade. And yet, as far as we know, no

employees spoke up. It seems clear that some must have known that something was wrong. So far, 15 former HealthSouth employees have pleaded guilty to manipulating the company's financial results. And Italian newspapers have reported that Parmalat employees used to joke about the company's huge, fake contracts with Cuba that, if real, would have flooded the island with Parmalat milk. Most of those employees were not directly benefiting from the fraud.

So why did no one speak up? Because blowing the whistle is too big a risk. Who wants to hire an employee who had "spied" on his previous employer? And within organizations, loyalty pays more than honesty. Inquisitive board members, for example, are often isolated and not asked to stay on.

If people who ask questions are ostracized, whistle-blowers often face a much worse fate. A 1992 survey of 1,500 federal workers who reported misconduct provides a snapshot of the consequences: Twenty-five percent experienced verbal harassment and intimidation; 20 percent were shunned by co-workers and managers; 18 percent were assigned to less desirable duties; 11 percent were denied a promotion. A 1998 survey of 448 emergency physicians is even more bleak: Twenty-three percent of those who complained about an issue reported having been fired or threatened with termination.

While most of the systematic evidence is about whistle-blowers in the public sector, corporate whistle-blowers do not seem to have it easier. Darryll Bolduc, a NationsBank bond trader, pointed out alleged trading irregularities at the bank, which is now part of Bank of America, in 1995. He lost his job as a result, he alleged in a lawsuit that was settled out of court, and found it difficult to get a new one. More recently, Peter Scannell, who blew the whistle on Putnam Investments' alleged after-hours trading, sustained serious head injuries when he was beaten by unknown assailants, who mentioned Putnam several times and warned him to shut up. Even former Treasury secretary Paul O'Neill is learning how harsh the reaction against whistle-blowers can be.

Given that whistle-blowers are essential to detecting -- and perhaps deterring -- corporate fraud, the solution seems obvious: Reduce fraud by compensating the whistle-blowers financially. It is not enough to protect them against wrongful dismissal (as Sarbanes-Oxley does). To be effective, the award should be proportionate to the size of the fraud exposed. The Parmalat fraud would not have lasted 15 years if there had been a formal way of rewarding whoever helped identify the fraud.

Just how would the reward system work? The whistle-blower would be entitled to collect a percentage -- let's say 10 percent -- of all fines and legal awards imposed on the company or the individuals responsible for the uncovered fraud. So in the Enron case, when Fastow agreed to pay about \$23 million in fines to the Securities and Exchange Commission, former Enron executive Sherron Watkins, whose revelations helped expose the case, would have collected \$2.3 million. It would be tantamount to a finder's fee, not dissimilar in its rationale to lawyers' contingency fees. Lawyers, after all, receive 30 percent of legal awards to induce them to assist clients and, in so doing, to help punish

illegal behavior. Why not apply the same logic to whistle-blowers, who put their careers (and sometimes their lives) at risk?

A reward like this would not be unprecedented. The federal False Claims Act allows anyone who knows that an individual or company has financially defrauded the federal government to file a "qui tam" lawsuit to recover damages on the government's behalf. Whistle-blowers are entitled to 15 to 30 percent of whatever the government recovers. Since 1986, the government's take has been more than \$3.5 billion.

Would the financial incentive generate a witch hunt? I doubt it. The law should not encourage employees to blow their whistle publicly, but only to the competent authority (such as the SEC). And if after a trial period it is clear that too many frivolous accusations are being made, we can fine-tune the mechanism: Those who make false claims could face a fine. But I doubt this will occur. Even with the award, standard loyalty will prevail and, I predict, the amount of whistle blowing will be too little, not too much.

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