The Journal of Socio-Economics 34 (2005) 734–755

The Journal of Socio-Economics

www.elsevier.com/locate/econbase

"Control frauds" as financial super-predators: How "pathogens" make financial markets inefficient

William K. Black *

Institute for Fraud Prevention, LBJ School of Public Affairs, E2700, University of Texas at Austin, P.O. Box Y, Austin, TX 78713, USA

Abstract

White-collar criminology scholarship shows that "control frauds" (frauds led by the CEO) use accounting fraud to deceive (or suborn) sophisticated financial market participants. Large control frauds cause greater financial losses than all other forms of property crimes combined. Weak regulation, supervision and ethics produce epidemics of control fraud that cause systemic economic damage. As with the natural world, these financial super-predators act like pathogens that take over a firm and act as a "vector" to cause ever greater damage. Control fraud theory poses a major challenge to the efficient markets hypothesis and the resulting praxis that devalues financial regulation.

JEL classification: D21; D43; D82; G18; G28; G38; K22; K42; L51; M42; O16; O17

Keywords: Control fraud; Lemons markets; Fraud; Regulation; Efficient markets

1. Introduction

I coined the term "control fraud" to describe situations in which those who control firms or nations use the entity as a means to defraud customers, creditors, shareholders, donors or the general public (Black, 2005, 2003).[1] In the United States and many other nations,

* Tel.: +1 512 475 8752; fax: +1 650 593 5921.
E-mail address: b.black@mail.utexas.edu.

[1] I use the phrase "control fraud" in two different ways in this article, and try to make sure the context makes the usage clear. I use the phrase to describe both the individual (typically the CEO) who directs the fraud and the type of fraud being committed.

1053-5357/$ – see front matter © 2005 Published by Elsevier Inc.
doi:10.1016/j.socec.2005.07.026

private sector (for-profit and not-for-profit) control frauds cause greater financial losses than all other forms of property crimes combined (Black, 2005). Public sector control frauds, also known as kleptocracies, cause enormous losses that can keep entire nations locked in poverty for generations. This article deals only with control frauds in for-profit firms. It shows why markets, regulators and criminal enforcement bodies have severe difficulties preventing such frauds. The inherent difficulty of dealing with control fraud and our lack of understanding and resultant inattention to control fraud explain why such frauds produce the great bulk of all financial losses from property crime.

In the context of blue-collar crime it has become common to refer to certain criminals as "super-predators" (Bennett et al., 1996: 26–34).

> America is now home to thickening ranks of juvenile "super-predators"—radically impulsive, brutally remorseless youngsters, including ever more preteenage boys, who murder, assault, rape, rob, burglarize. . . (Id. 27).

There has been a sharp rise in the number of child and teen criminals who commit extreme violence. The crimes they commit are a major social problem. These criminals, however, as the authors' own description shows, are not true super-predators. Being a "radically impulsive" pre-teen is a very poor strategy for a human predator, it usually leads to either prison or early death at the hands of a more competent predator. These so-called super-predators live in the richest nation in the world but prey overwhelmingly on the poorest citizens and are rarely even seen in middle class neighborhoods.

The emphasis on toughness and remorselessness reflects our usual bias in discussing predators. The true super-predators are pathogens. They deal death in vastly greater numbers than do carnivores (Diamond, 1997). Their host is a victim, and a weapon that spreads disease. The same bias towards "macho" predators that long dominated zoology has shaped the dominant criminology metaphor for major corporate crimes. Wheeler and Rothman's seminal article (1982) on the corporation as a "weapon" and "shield" in white-collar crime was a major advance. Its imagery, however, calls to mind the armed warrior who triumphs by hacking victims or intimidating terror. This imagery suggests that corporate frauds operate openly. The public and the government know who the frauds are but the corporate frauds are so powerful that can plunder with impunity.

I offer a revised metaphor in which control frauds are the pathogenic super-predators of the United States. As the former savings and loan commissioner of California, William Crawford, explained: "The best way to rob a bank is to own one" (U.S. Congress 1988: 34). The chief executive officers (CEOs) who commit control fraud do not look like predators. They want to appear to be pillars of their communities and their firms to appear healthy.

Control frauds can use the firm as both the victim and weapon of fraud. They subvert the firm's legitimate structure and objectives to the short term advantage of those who control them. In the process, they typically follow one of two paths. Some control frauds deceive customers. George Akerlof's famous 1970 article about "lemons markets" (which led to his Nobel Prize in economics) first identified this form of fraud in the economics literature. These frauds were possible because information was asymmetrical. The seller knew far more about the true quality of the goods than the buyer, and the seller exploited that information advantage by misrepresenting the quality of the goods. Akerlof showed that this could produce (initially) supra-normal profits for fraudulent sellers and make it impossible for