

Market Psychology: The Fraud Triangle

☒ Are you a good person?

James Bagarozzo thought he was. His family probably thought he was. He was working to put food on their table and save for his daughters' college years. But over 8 years, instead of fixing parking meters like he was supposed to, he broke them in advance so quarters would collect on top, where he could steal them rather than dropping them into the collection can. His total take was roughly \$210,000 in quarters from Buffalo parking meters.

Mr. Bagarozzo wanted to save for his family, but he thought he had an illness that would kill him before he could do so. He blamed his criminal activities on this thought and on a gambling addiction. He was sentenced to two-and-a-half-years in jail.

Was he a good person doing bad things, or was he a bad person?

Dr. Donald Cressey wrote his dissertation for his criminology Ph.D. in 1950. He noticed that most embezzlers thought of themselves as "good people", but if they're "good" then why did they embezzle? His work published in 1953 as *Other People's Money* continues to be the classic model to explain why white collar crime takes place, and under that model Mr. Bagarozzo isn't that different from Bernie Madoff.

Here "white collar crime" includes embezzlement, non-violent theft of money, deliberate breaches of corporate compliance, and securities law breaches like unlawful insider trading and tipping. These include the smallest of thefts like taking pens home from the office, all the way to stealing millions of dollars. The person committing that white collar crime will be "Kelly".

Dr. Cressey's Fraud Triangle has three sides: need, opportunity and self-justification.

First, need: there has to be a need or pressure, so great that it seems overwhelming and insoluble. Kelly might have a gambling problem and in deep to the bookie, or Kelly needs to fund a drug addiction, or might have allowed household debt to run rampant. Whatever the cause, the future looks bleak.

Red flags to look for: did Kelly recently get separated / divorced? Expensive child or spousal support payments? College payments looming? Evidence of addiction? Does Kelly never take a vacation (helps to conceal the crime).

Second, Kelly sees an opportunity to first commit and then get away with the fraud. As a Governance Specialist, I see this side of the triangle the most. Companies fail to put simple controls in place, or even worse, put them in place but don't follow them, giving Kelly a chance to pillage the treasury.

The case involving Mr. Bagarozzo is a perfect example of that. A few simple controls would have eliminated his ability to steal from the meters. One simple change would be, send the parking meter collectors on a different route every day, and only tell them of the route that morning. The opportunity to break certain meters in advance would be eliminated.

In the corporate world, controls are a major part of the everyday processing of money. Who gets to authorize what payment for what reason in which circumstances? Controlling the day-to-day mundane processes helps keep the entire system clean and working. The annual audit specifically addresses the quality of the controls in place.

A breakdown in controls was one of the factors allegedly leading up to the recent McGill University/SNC-Lavelin bribery scandal. A total of \$22.5 million was allegedly funnelled through shell companies to the former head of the McGill University Clinic, Arthur Porter, and his wife, Pamela Porter,

to influence the awarding of the massive construction contract to SNC. The trial is pending.

Third, according to Dr. Cressey, Kelly must be able to rationalize the negative emotions typically associated with theft. Kelly justifies the crime with rationalizations like: I don't get paid enough for the work I do; they didn't give me the bonus I expected; my leg hurts from this job; I was going to pay it back; my family needs it; it's not my fault. And the real killer rationalization: everyone else around here does it.

Back to Mr. Bagarozzo. He and other city employees came under scrutiny after someone noticed that the new computerized pay stations were taking in more revenue than did the human-managed meters. Since the arrest of Mr. Bagarozzo and another employee, Buffalo's annual parking meter revenue increased by more than \$500,000. This tells us that other employees were doing the same thing: everyone else around here does it, so it's OK for me to do it as well.

Some people steal more than 25 cents at a time. We remember the more recent cases of white collar crime (Madoff, Enron, Drabinsky), but do your own research on these older cases and you'll see each leg of the Fraud Triangle:

- Michael Milliken led Drexel Burnham Lambert into bankruptcy in 1990. After pleading guilty to six counts of securities fraud he was sentenced to 10 years in prison, ordered to pay fines totaling \$600 million, and permanently barred from the securities business;
- Charles Keating, the face of the Savings and Loan scandal of the 1990's, swindled his own depositors and investors for roughly \$34M;
- Julius Melnitzer, a very well-liked high profile lawyer in Ontario, pled guilty in 1991 to 43 counts of fraud and making false documents. He used more than \$100-million worth of fake stock certificates as collateral

for \$67-million in loans;

- Ron and Loren Koval, sentenced for 7 years after pleading guilty in 1991 to two counts of fraud totalling \$94M against financial institutions related to fake equipment purchase for the King's Health Centre in Toronto.

Were these 'bad people'? Would you have acted any differently in similar circumstances? To put it more bluntly, have you stolen anything from your employer? Pens, scissors, paper? Cheated on your significant other? Deliberately cheated at sports (like golfers who can't count)? Lied on your income tax return? Smuggled undeclared alcohol across the border? Sped down residential streets?

'I needed to do it, I knew wouldn't get caught, and other people do it too so what's the problem?' Need, opportunity, justification. It's the same mindset – it's just the number of zeroes that's different.

Better compliance and better governance attack all three legs of the Fraud Triangle. We need boards of directors to be vigilant in challenging management. We need management working together as a system of balances and checks. Staff and management must clearly communicate their respective needs. Auditors need to be a functional part of the team, not merely parroting theoretic IFRS pronouncements. Shareholders must intelligently question the board and management. Lenders have to regularly review the borrowers' affairs. With public companies, analysts have to do real independent analysis, even where critical of management, and not be promoters for the investment banking group.

Attack the need, the opportunity and the rationalization. And that means the best way to shatter the Fraud Triangle is to create a culture of compliance. Leaders must lead, by word and deed.

Employees know when management is slipping – the fish rots from the head down. A lazy approach to compliance from a management team will trickle down to the staff taking a similar approach. And once the culture goes rotten, it's time to dial up the expensive lawyers and the damage control public relations specialists. That means prevention is key: compliance must find its way into everything a company does internally and how it interacts with the outside world. Controls and procedures must be created, entrenched and followed, to eliminate opportunity, and to weaken the rationalization process. Well-run companies have systems in place that make it possible for each employee to succeed while minimizing the risk of white collar crimes.

Here's a recent example of leaders creating a culture of compliance. Major League Baseball, with the support of the powerful players union, banned its players from playing in any fantasy sports league for prizes, as part of a larger prohibition against gambling. No fantasy football, no March Madness, no Masters Pool. Baseball players can't bet on anything involving sports. MLB is taking it seriously: earlier this year Florida Marlins pitcher Jarred Cosart was fined an undisclosed amount by Major League Baseball for unspecified gambling related offences involving his Twitter account.

We grumble about mundane over-reaching human resources protocols, or about the latest dull inquiry from the securities lawyers, but that's because we're in the majority and don't see the need for us to do it. We're good people, after all, just like James Bagarozzo.