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## WHO BLOWS THE WHISTLE ON CORPORATE FRAUD?

*Alexander Dyck*  
*University of Toronto*

*Adair Morse*  
*University of Michigan*

*Luigi Zingales\**  
*Harvard University, University of Chicago, NBER, & CEPR*

### ABSTRACT

An effective governance system has mechanisms in place to detect and bring frauds to light so that misallocation of resources can be stopped. But what control mechanisms are most effective in preventing corporate fraud? We address this question by studying in depth all reported cases of corporate fraud in companies with more than 750 million dollars in assets between 1996 and 2004 where there are grounds to argue that the frauds are not frivolous. The resulting sample of 243 corporate frauds includes all of the high profile frauds such as Enron, Healthsouth and Worldcom. We find a very limited impact of investors, either large block holders or more disperse shareholders through litigation, in bringing fraud to light. Stakeholders, government agencies, and newspapers, by contrast, play a very important role accounting for 17%, 15% and 10% of the cases respectively, the lion's share of stakeholder cases accounted for by employees and government agencies by industry rather than security regulators. Analysts are important whistleblowers, accounting for 10% of our cases and are the most efficient whistleblowers that aren't company insiders (on average they discover a fraud after 395 days). When they fail it takes two years on average for a fraud to be discovered. We see increased activity of auditors and the SEC following the Enron scandal and passage of Sarbanes-Oxley.

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The onset of the new millennium coincided with remarkable revelations of corporate fraud, not only in the United States, but around the world. These frauds are remarkable not only in their magnitude, but also their duration. For instance, the HealthSouth fraud, where all 5 former CFOs pleaded guilty to criminal charges surrounding earnings and asset manipulation of more than \$2.5 billion, had been in existence for over ten years. In the Parmalat case, it appears that fraud persisted throughout the 13 years the company was public. In the end, not only were the earnings false, but liabilities were 14 billion euros more than Parmalat's official accounts. The magnitude and the duration of these frauds suggest a systematic failure of many standard mechanisms of control: the board of directors, the external auditors, the banks, the underwriters, the analysts, and the financial market regulators.

Fortunately, these extreme examples are rare, especially in the United States. Nevertheless, more modest and less long-lasting frauds do occur frequently in the United States. Just as the Federal Aviation Authority (FAA) studies all airplane accidents, however minor, to identify ways to prevent failures which might lead to major crashes, in this paper we study a comprehensive sample of alleged frauds to identify sources of the most serious problems, and, critically, to identify the control mechanisms that eventually come into play to flag these problems. The better the process for exposing misdeeds, the more limited will be the magnitude and the duration of corporate frauds, stopping transgressors before insider misdeeds reach levels of an Enron or a Healthsouth. The results from this exercise will suggest which actors are important and which are not, and may prove useful in efforts to limit the extent and impact of corporate frauds in the United States and to highlight which corporate governance mechanisms would be important for other countries to adopt.

To assemble a sample that captures the most significant cases of corporate fraud, we start from the Stanford database of security class actions brought against companies with at least 750 million in assets (in the year before the fraud comes to light) in the years 1996 to 2004. Since in major companies (i.e. companies with sufficient assets and with sufficient insurance to motivate plaintiff lawyers) any fraud will lead to a security class

action (Choi, Nelson and Pritchard, 2005), we are confident that we have all the (detected) cases of fraud occurring in large, publicly-traded, companies.

The risk of this sample is that it might include frivolous suits. To minimize this risk we restrict our attention to the period after passage of the Private Securities Litigation Reform Act of 1995 (PSLRA). This act was designed to reduce frivolous suits (e.g., Johnson, Kasznik, and Nelson, 2000; Johnson, Nelson and Pritchard, 2003). Furthermore, we restrict our attention to cases that settled for at least \$2.5 million, a level of payment previous studies suggested helps divide frivolous suits from meritorious ones (Grundfest, 1995), and take further steps to address such concerns.

This sample of alleged frauds<sup>1</sup> allows us to ask a number of questions: which types of fraud are most severe? Which mechanisms generally work in bringing these frauds to light? Is there a specialization in the detection of fraud (i.e., are auditors better in detecting financial frauds, while regulators in finding out about illegal activities)? What are the circumstantial factors that facilitate the revelation of fraud? Which whistleblowers act more quickly than others, lowering the duration of the impropriety? And is this fraud detection process influenced by increased public pressure and awareness, as occurred after the spectacular downfall of Enron in 2001 and the passage of Sarbanes-Oxley in the summer of 2002? One advantage of this approach is that we do not restrict *ex ante* to one particular set of mechanisms, but we let the data tell us which mechanisms work and when.

To construct the sample we start by collecting all news articles surrounding the period of fraud, as well as the news up to the settlement or dismissal of the case. By reading allegations, news articles and newswires, we identify the nature of the fraud, its likely motivations, who blew the whistle on it and under what circumstances. Finally, we record the duration and the monetary settlement amount.

Analyzing these data, we find that 85% of the cases involve misrepresentation of financial statements or failure to disclose. In only 5% of the cases is the primary allegation of self-dealing, suggesting that the most severe agency problems are well

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<sup>1</sup> In what follows we will drop the term alleged and simply refer to frauds. While a number of these cases have settled with findings of fact of fraud, the majority of suits are settled for financial payment without any admittance of wrongdoing and remain allegations.

contained in the United States. The remaining 10% of the cases involve other illegal activity, such as price fixing or failure to comply with industry regulation.

Our investigation of likely motives for the fraud is supportive of this allegation evidence where we find in only 17% of the cases of fraud is the primary motive appear to be direct personal profit. The bulk of frauds are driven by the desire to finance a company's organic growth (20%) or its acquisition strategy (21%), or to hide problems created by an industry downturn (11%) or a drop in earnings (15%).

Perhaps our most interesting findings are on the identity of the whistleblower. In one quarter of the cases, it is the firm itself that reveals the wrongdoing. This generally occurs after a change in company's management or when the company finds it difficult to keep lying to analysts regarding its losses. This never happens, however, when there is a criminal aspect. Firms never voluntarily reveal fraud that brings with it criminal consequences.

Two thirds of the alleged frauds, however, are identified by actors that are not part of the internal governance of the firm. These whistleblowers include stakeholders (17% of these cases), regulators (15%), newspapers (10%) and analysts (11%), the first three of these actors being notable as they are not normally at the heart of governance discussions. In the stakeholder category, employees are the most important group, and in the regulator category it is industry not security regulators that account for the bulk of the whistle blowing.

As interesting as these results are in identifying who blew the whistle, perhaps a more striking result is who *did not* blow the whistle. Private litigation itself does not seem to play any role in the revelation of fraud. This does not mean that it is useless to prevent fraud, since it could be the mechanism through which people committing fraud are forced to pay for their mistakes. But it does suggest that this mechanism cannot work alone. It needs another (vast) set of institutions to help bring fraud to light. Other prominent actors in traditional discussions of governance that are completely absent are stock exchange regulators, commercial banks, and underwriters. Notably, large investors on both the equity and debt side are decidedly a side-show, only accounting for 3% of cases.

We then ask two additional questions. First, what factors trigger whistle blowers to act? To address this question we gather information about the context surrounding this

decision. We find that routine earnings announcements are the single greatest trigger factor in the uncovering of the fraud – when faced with disappointing earnings, and lacking a convincing alternative story, firms can simply admit their misdeeds, accounting for 16% of our observations. External events also seem to force a revelation of the fraud. A negative operations shock (16% of cases) such as a product failure or loss of a client may also force the firm to admit the fraud. Earning announcements and operational failures also appear as triggering factors for outside whistleblowers, providing motivation and source material for outside investigations into firm practices and financial imbalances. Added scrutiny need not be induced by firm announcements; outside scrutiny events (also 16% of cases) such as due diligence and industry routine investigations also are important in bringing fraud to light.

Finally, how efficient were the various whistle blowers? Since all of them can be considered competing sources for bringing fraud-limiting news to light, the speed with which the information is brought to light provides an indication of the relative efficiency of these different mechanisms. By this measure, analysts and the firm itself are the most efficient actors in curtailing fraud to durations of just more than a year, significantly less than the average duration of 1.6 years. When this first line of defense fails, other actors seem to bring the information to light in similar periods of time, almost 2 years on average.

In conducting analyses of the actors, the trigger factors, duration and motivation, we also pay attention to changes over time. Notably we divide our sample into pre- and post-Enron subsamples, motivated by the change in public attention to corporate scandals surrounding Enron's rapid fall in October of 2001, and the ensuing discovery of huge frauds elsewhere including Worldcom that collectively spurred the passage of Sarbanes-Oxley. This division provides some direct evidence consistent with the contention that heightened scrutiny and public attention changed the enforcement environment, although it is hard to disentangle the possible impact of the change in market returns on the enforcement environment.

This work relates most directly to the burgeoning literature on corporate governance and law and finance that has focused on the allocation of rights between investors and insiders, and the legal sanctions, processes and penalties available to

investors. Here, by highlighting the discovery rather than the penalty phase, we provide complementary evidence on critical actors and processes. Our findings provide support for a broad view of governance that incorporates a range of actors outside of the firm, and notably outside of the usual discussion of governance - including newspapers, employees, and industry-specific regulators. These actors are pivotal in the governance process of exposing the large frauds that have been at the center of governance debates and reforms.

The remainder of the paper proceeds as follows. Section 2 explains the data and sample selection process. Section 3 describes our descriptive results. Section 4 presents our analysis of the efficiency of whistleblower, both by type of fraud and by speed of detection. Section 5 reexamines our prior results to see if the changed governance environment following Enron and Sarbanes-Oxley influenced Whistleblower activity. Section 6 provides conclusions and implications.

## **2. Data**

### *Selecting the Sample*

Ideally, we would like a sample that includes all firms where the company and/or its officers engage in fraud. A natural starting point to construct such a sample is with class action lawsuits that contain allegations of fraud. We therefore begin with all companies subject to lawsuits that are available in the Stanford Securities Class Action Clearinghouse. The Stanford Securities Class Action Clearinghouse identifies the period of alleged abuse, the date of class action filing, summary of complaint, court of certification, result of the lawsuit including whether dismissed, and the financial penalty paid, if any.

We restrict our attention to the larger firms in this sample, because for these firms there are strong incentives for law firms to identify any fraudulent activity and to initiate lawsuits. For these larger firms, this sample is likely to capture any alleged frauds that have come to light because class action law firms have automated the mechanism of filing class action suits such that in the case of any negative shock to share prices for a larger firm, they immediately start searching for a cause to file a suit. Since in the United States stock prices drop following revelation of most serious corporate frauds it is therefore highly unlikely that a corporate fraud would emerge without a subsequent class

action suit being filed. In most cases, investigations by the SEC or other authorities come subsequent to class action suits. Operationally, we restrict our attention to firms with at least \$750 million in assets in the year prior to the end of the class period (as firms may reduce dramatically in size surrounding the revelation of fraud).

A problem with this ‘fraud sample’ is that it may be overinclusive, including alleged frauds that are invalid. We introduce four filters to address such concerns. First, we restrict our attention to the period from 1996 -2004, specifically excluding the period prior to passage of the Private Securities Litigation Reform Act of 1995 (PSLRA) that was designed to reduce frivolous suits. Second, we further restrict our attention to cases that have not been dismissed, something that was easier to achieve following the PSLRA.

<sup>2</sup> Third, for those class actions that have settled, we only include those firms where the settlement is at least \$2.5 million, a level of payment previous studies suggested helps divide frivolous suits from meritorious ones.

Grundfest (1995), Choi (2004) and Choi, Nelson, and Pritchard (2005) suggest a dollar value for settlement as an indicator of whether a suit is frivolous or has merit. Grundfest establishes a regularity that suits which settle below a \$2.5 - \$1.5 million threshold are on average frivolous. The range on average reflects the cost to the law firm for its effort in filing. A firm settling for less than \$1.5 million is most almost certainly just paying lawyers fees to avoid negative court exposure. To be sure, we employ the high end of the range (\$2.5 million) as our cutoff.

Fourth, we identify in the course of doing the case studies a handful of firms that settle for amounts greater than \$2.5 million, but where the fraud, upon our reading, seems minor, and we fear have settled to avoid the publicity as these firms are often high profile firms. The rule we apply is to remove cases in which the firm’s poor ex post realization

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<sup>2</sup> If the suit is not dismissed, negotiations commence among the parties, which can be prolonged by waiting for the outcome of other investigation testifying to the validity of fraud claims. Cases never reach the point of having a court verdict for the simple reason that Directors and Officers’ Liability insurance contracts do not cover liabilities in which securities fraud are proven in court. Thus, if the suits are not dismissed in initial hearings, the executives of the defendant firm always force settlement of the case. The time in between the dismissal ruling and the settlement is spent bargaining for settlement on the strength of the claim.

The moral for us is that beyond ruling out cases which are dismissed or not certified, there is no verdict to which we can default in asserting that the firms we study have in fact committed fraud. Some cases are settled by firms to remove the nuisance, insurance risk and publicity exposure of going to court. Therefore, the fact that a case settles does not directly imply that the firm actions were fraudulent.

could not have been known to the firm at the time when the firm or its executives issued a positive outlook statement for which they are later sued. This filter removes 14 cases.

Finally, we exclude from our analysis trading frauds such as was associated with mutual fund trading as these frauds are quite different than the other frauds in our sample.

#### *Procedure to identify whistleblower and other variables*

For each of the 243 cases, we manually collect information on the fraud and its detection from Factiva newswires. We compile data for a variety of fields including – *settlement date and amount, class period, impropriety, motive, whistleblower, and trigger factor*.. In this subsection we define these fields and describe the data collection in the context of the flow of preparing a case study.

In the pre-screening searches to determine if a case is dismissed or settled below the \$2.5 million threshold, we collect *settlement amounts* and *settlement dates*. Firms are not required by law to disclose settlement details, but they frequently do. Their balance sheets generally have already accrued for the expense, and their annual reports have already notified shareholders of an exposure to the suit. Thus, a settlement represents a closure to an uncertainty.

The second step in each case study is to identify the time period and allegations for the fraud. We at least search Factiva over the range one month before and after the suit date given in the Stanford Clearinghouse, looking specifically for law firm newswires announcing the class action suit. Often there are multiple law firms announcing suits for a particular litigant. From the suit announcements, we extracted the *class period* defined as the maximum spread of time over which the fraud was allegedly committed.<sup>3</sup>

The next step in each case is to conduct a thorough search of news reports on the firm beginning three months prior to the class period and going until the *settlement date* or until current (summer, 2005) if the case is yet pending. As a first pass, we limit searches to having the firm name in the first 30 words of the article, but we do not restrict

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<sup>3</sup> The Stanford Clearinghouse also contains information on allegation categories and class periods. We supplemented our information with that in Stanford when Stanford had additional information. Unfortunately, the Stanford allegation data are yet incomplete for periods past 1999, and upon occasion, the class periods in Stanford are inconsistent with those reported in newswires.



the media source from which the article might be drawn. In a number of cases, local newspapers conduct more thorough investigative reporting of local firms, and thus we sacrifice having to read more articles rather than miss such important fact-finding. Where it is useful we extend the search window both earlier to see if prior indications of weakness, and post the suit date to identify subsequent court findings, SEC investigations and subsequent evaluations.

Our searches return an approximate average of 600 articles per case. The number of articles increases with length of the class period, the severity of the allegation, and the size or media exposure of the litigant firm. The number of articles per firm also generally increases during and following the Enron scandal.

### *Variables*

The large set of articles first provides us with material to develop a full understanding of the chain of events surrounding the scandal, and second allows us to uncover answers to a series of questions. Our first question is: what misconducts are behind the allegation? The improprieties generally fall into false disclosures, misrepresentations, and engagement in illegal activities.

A second question follows from the identification of improprieties: what was the motive for the fraud? The *motive* category tries to understand why the fraud occurred. A variety of motivations are possible. These include the possibility for the top executives to personally profit from the fraud, for example attaining a significant bonus payment tied to accounting numbers or share price appreciation, or direct benefits in terms of self-dealing. But this is not the only possible motivation, other possibilities including the possibility to continue growing (e.g. needing a strong share price to support acquisitions financed with equity), or even a desire to increase company value by engaging in practices that generate increased profits but if identified are likely to bring legal sanctions. Since motives are not directly observable we impute likely motives from an extensive reading of the onset and development of the fraud in news accounts, lawsuit testimony (where available), SEC findings (where available) and other sources. The *motive* category helps us to understand the context of the fraud.

The third, and most central question for this study, is: who is the whistleblower? The *whistleblower* field is not restricted to be a person; rather we define the

whistleblower as the entity which forces the fraud to light. Our set of whistleblowers includes items falling under the broad categories of internal governance, stakeholders, reputation intermediaries, regulators, and information intermediaries.

Often, we find that the whistleblower is not the person labeled by the media as such. A chain of events initiated by another entity may already be forcing the scandal to light when an individual expedites the process by disclosing internal information. For instance, Enron's whistleblower by our classification is the Texas edition of the Wall Street Journal not Sherron Watkins who is called the Enron whistleblower in the media. Of course, we do not want to discredit the importance of internal individuals identified as bringing fraudulent activity to the public. However, our aim is to identify the initial force that starts the snowball of a scandal coming to light. In the Enron example, investigative reporting by the Texas version of the Wall Street Journal raises concern about Enron's marking-to-market practices and the source of firm revenues a full 8 months prior to employee whistle blowing.

Also closely associated with the whistleblower is the question: what were the triggering factors that forced the whistle to be blown in general? The *trigger factor* field captures the pressures that caused the whistleblower to bring the fraud to light at that time.

*An Example (to be completed)*

### **3. Results**

In Table 1 we start by analyzing the nature of the fraud. 85% of the cases involve misrepresentation of financial statements or failure to disclose. Only 5% of the cases involve self-dealing, suggesting that the most severe agency problems are well contained in the United States. The remaining 10% of the cases involve other illegal activity, such as price fixing or failure to comply to industry regulation.

Table 2 provides supporting information. In examining motives we identify only 17% of the cases where the likely primary motive is direct personal profit.<sup>4</sup> The bulk of the frauds appear driven by the desire to finance a company's organic growth (20%) or its acquisition strategy (21%), or to hide problems created by an industry downturn (11%) or a drop in earnings (15%). Note that each category is based on a richer initial categorization. For example, we classified organic growth as a motive where the onset and development of the fraud were associated with capital raising either through equity (initial public offering or seasoned equity offering) or debt (bank financing or public debt issuance).

Table 3 presents the distribution of whistleblowers. We distinguish between eight categories ordered according to their 'distance' from the firm. Here distance can be interpreted in two ways: distance in terms of information sources (with directors being the closest ones and regulators being the most distant) and distance in terms of impact of company's value on the welfare of the potential whistle blower (with managers and blockholders and managers being the most exposed and regulators the least). Within each of these categories, we have the main components of each group. The first column reports the number of cases, the second the percentages, the third the duration in time, and the fourth the settlement amount when known.

As Table 3 shows, more than a third of the cases are brought to light by the firm itself (25%), its officers (2%), and its Board (7%). Blockholders do not seem to play any major role in detecting fraud (only 3% of the cases). Stakeholders, by contrast, play a very important role with 17% of the cases. The lion share of this is represented by employees, who blow the whistle in 12% of the cases. Interestingly, employees are as important in detecting fraud as auditors (10%), whose job should be to uncover irregularities.

The third major source of information on fraud is represented by analysts (11% of the cases), followed by the media (10% of the cases). Regulators collectively lead to the discovery of 15% of the cases, but this role is very unequally distributed. The SEC, the agency in charge of monitoring publicly traded company, is quite absent (only 3% of the

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<sup>4</sup> This is not to say that those committing the fraud do not see some personal profit, as there often is a gain on existing stock or options, particularly if the executive sells stock prior to the revelation of the fraud. To be counted in the personal profit category, the gain had to be sizable as in the case of Adelphia.

cases). A much bigger role is played by industry regulators (7%), and this is an underestimate of their impact as they are only present and capable of detection in a fraction of our cases.

Equally interesting to who blows the whistle is who does not. Private litigation itself does not seem to play any role in the revelation of fraud. This does not mean that it is useless to prevent fraud, since it could be the mechanism through which people committing fraud are forced to pay for their mistakes. But it does suggest that this mechanism cannot work alone. It needs another (vast) set of institutions to help bring fraud to light. Other prominent actors in traditional discussions of governance that are completely absent are stock exchange regulators, commercial banks, and underwriters.

Very important is also the role played by employees. While all the other whistleblowers are either paid to investigate (regulators and auditors) or can profit from revealing corporate frauds (analysts and media), employees not only are not paid, but very often face a direct cost (loss of the job) to reveal the information.

Table 4 describes the factors that triggered the revelation by the whistleblower at that point in time. Many actors face costs in blowing the whistle – individuals face shunning from their co-workers; firms may lose product market clients and reputation; auditors lose contracts; etc – so it is very rare that frauds are brought to light by accident. There is usually a context or triggering factor that leads a firm or an individual to blow the whistle. These triggering factors can usefully be divided up between those arising from inside the firm (48% of the cases), and those where the major pressure is external to the firm (40 % of the cases).

The most important triggering factor coming from within the firm is a negative shock to the business (16%). The business shocks often appear in the form of a product failure or loss of a client. A prime example comes from the case of FirstEnergy, whose poorly maintained power facility caused the largest power outage in North American history. The product failure, ironically, triggered the discovery of accounting fraud. Following close behind in importance (13%) is restructuring and executive turnover that often creates new winners and losers within the organization and leads to public

discussion of internal disputes.<sup>5</sup> In the case of CEO turnover, not only do new CEOs undo previous CEOs' acquisitions (Weisbach, 1998), but they also expose their wrongdoings.<sup>6</sup> Completion of financing events (7%), change in auditors (7%) and financial distress (4%) also contributed to whistleblower actions.

While these internal pressures are important, the single most important triggering factors comes from outside the firm in the requirement to make routine earning announcements (18% of observations). Firms and their management are very aware of these quarterly obligations and are afraid to face the analysts without a compelling story. When one cannot be found, it is potentially easier to admit the possible wrongdoing. In the hardware maker 3Com's case, for example, the firm's unusual inventory-to-revenue quarterly figures sufficiently intrigued the *San Francisco Chronicle* as to lead the paper to investigate the production of 3Com's newly acquired U.S. Robotics division. The truth soon emerged that contrary to its revenue reporting, U.S. Robotics had not even been in production, and that much of 3Com's other revenues were only the result of channel stuffing.<sup>7</sup>

Outside scrutiny likewise is an important factor (14%). In the Healthsouth case, for example, a company CFO eventually blew the whistle by bringing evidence to the FBI of systematic and prolonged manipulation of the financials, but this only happened when many in the company feared the 'game was up' as there was increasing government scrutiny following from a not directly related allegation of insider trading, and there were rumors of impending interviews of top executives.

Fallout from scandals is another important category (7%), with increased concern about scandals in related areas or industries spurring whistleblowers to action. An increase in the alertness of the public to certain problems can force firms to come clean or facilitate potential whistle blowers to come forward. Scandal fallout is not only an

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<sup>5</sup> Phycor provides one example where disputes between teams of doctors and company management over payments for centrally provided resources sparked lawsuits by the physicians to get out of these constraints, and lead to revelation that the roll-up of physician groups was not delivering returns consistent with management statements.

<sup>6</sup> In the case of Rite Aid, after the former CEO is fired for inventory irregularities and general poor performance, the new CEO discovers that the previous executive had pledged the company's assets on short-term debt and then falsified the records for board approval.

<sup>7</sup> Channel stuffing is accomplished by filling the downstream distribution lines with excess production to inflate current sales revenues, at the expense of future revenue recognition.

energy firm phenomenon; widespread usage of financing vehicles, for example, became an automatic trigger for attention by regulators.

#### *Which actors are faster to blow the whistle?*

All the whistleblowers can be considered as competing sources of negative news. If we start from the safe assumption that the sooner news about fraud emerges, the better, then we can measure the relative efficiency of the various mechanisms by comparing the relative duration of the fraud uncovered. Before analyzing the data, however, it is important to recall that the duration means come from very selected samples: frauds that have been uncovered.

Turning back to Table 3, we can see that early warning systems include analysts, the firm and employees. On average, analysts identify fraud that lasted for only 401 days (vs. an average of 583). Employees are slightly more efficient (398 days), while the firm is also efficient (415 days). Auditors (731 days) and regulators (657 days), while media and blockholders are in the middle of the range.

The picture that emerges is the following. Analysts, the firm and employees are able to bring to light some frauds relatively early. When this first line of defense fails, the second line takes much longer. This could be due to the fact that such frauds are more hidden or that these alternative mechanisms take much longer to have an effect.

#### *Settlements and Whistleblowers*

The far right column of Table 3 shows the mean fraud settlement amounts by whistleblower. To the extent that settlement amounts are a reasonable measure of the size of the fraud<sup>8</sup>, we can infer which mechanisms bring the important frauds to light. Employees and newspapers are the most important sources of information for large improprieties (roughly \$215 million for both). The second most important source of information on big cases is the auditors, who on average blow the whistle on cases that settle for \$114 million. The third most important source is insiders, with \$156 million on average.

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<sup>8</sup> This needs to be taken carefully for we are only identifying the settlement paid by the firm, and we are not including possible additional payments by auditors, banks and other parties that can also be involved in making settlement payments.

#### 4. Cross-sectional analysis

To draw a coherent picture of the effectiveness of whistleblowers we delve more into the relationship between the type of impropriety and the whistle blower identity. To make proper inferences about the relative success of whistle blowing groups, it is useful to ascertain whether whistleblowers compete in the market for information with each having its own comparative advantage.

##### *Whistleblower specialization*

Table 5 presents the estimates from a multinomial logistic regression in which the dependent variable is the categorical variable of the seven whistleblower types. The multinomial model is used to understand whether the realization of a particular whistle blower type is associated with types of improprieties. The model estimates coefficients capturing each specific whistle blower's association with each type of impropriety committed. Because the number of coefficients grows large in the multinomial block, we collapse improprieties into three categories to allow us to focus on the whistle blower variation. The three impropriety categories are illegal activities and non-compliances, misrepresentations on financial statements, and failures to disclose events or realizations pertinent to the firm. The last category will serve as our offset in the estimation since we would like to make inferences on the better-understood categories of financial mis-statements and actions which are illegal even without mis-reportings. We likewise must choose an offset for the whistle blower. Since our contribution is in looking outside the firm for governance, we set the internal governance category as the offset.

Column 1 of Table 5 shows an estimation that essentially replicates the distributional findings. Relative to internal governance mechanisms, whistle blowers are less likely, in increasing order, to be stakeholders, regulators, analysts, media, professional services, insiders and blockholders. Column 2 asks the central issue of whether there is a greater likelihood for whistle blowers to be linked to particular improprieties. Relative to internal governance whistle blowers, blockholders, professional services, regulators, stakeholders and analysts all are more skilled at

bringing illegal activities to light. Finally, professional services (i.e. auditors) and insiders are more skilled at bring misrepresentation on financial statements to light.

### *Competing risk model*

We are now in a position to analyze the speed with which whistle blowers uncover fraud. We can address the time efficiency of whistleblowers more formally in a competing risk framework. Competing risk models are variants of hazard rate analyses in which outcomes compete to occur first.<sup>9</sup> We estimate the risk of being detected by competing whistle blowers after controlling for an adjustment to the risk, common to all whistle blower categories, for the type of impropriety being committed. In other words, after taking out the risk of exposure due to the fact that some types of fraud are simply easier to detect, we calculate the risk of having one's fraud detected by the competing whistle blowers.

Table 8 presents the estimation results. Illegal activities and misrepresentation on financial statements are significantly harder to detect. Conversely, misrepresentations regarding selling off shares, division or firm, and firm value enhancement result in quicker detection. These results are consistent with our intuition. More serious crimes will be more deeply rooted in the firm, and thus, detection should take longer. When mergers or R&D finish their implementation, the frauds are often forced to surface.

Although these results are interesting by themselves, our primary goal of the competing risk model is to assess the speed of detection among whistleblower classes. For this, we estimate the survival rate from the estimation in column 1 of Table 8 for each of the stratified classes of whistleblowers. The survival function, defined as the probability of surviving another day given that the fraud has survived up to the point in question, is plotted in Figure 2 by whistleblower.

It is easiest to understand Figure 2 by first focusing on the dark line for the internal governance whistleblowers. The internal governance line is initially beneath all other lines, implying that if the fraud has not already been detected, the probability of surviving detection by the internal mechanisms of the firm are always lower than the

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<sup>9</sup> The word 'risk' comes from the fact that this genre of models first was, and still most frequently is, used in epidemiology studies.



probability of surviving other whistle blowing risk. Said another way, internal governance mechanisms pose the greater hazard for managers committing fraud. Even after controlling for impropriety type, the firm's internal governance detects fraud the quickest.

If the firm's governance mechanisms do not reveal the fraud, which we know to be true in 75% of the cases, which whistle blower move the slowest and the fastest to uncover the misdeeds? The fact that the blockholder line is uppermost in the diagram suggests that they pose the least risk for those committing fraud. Analysts, which are included in the all other category, are the most active for frauds of shorter duration, but the additional risk they impose on those committing frauds is short lived – from a half-year to a year and a half. Not coincidentally, the bulk of analyst whistle blowing occurs in this duration window. The categories stakeholders and employees and regulators are not very effective for low duration frauds but become much more of a risk for those committing fraud as the duration of the fraud extends.

Figure 2 leaves one final impression that is worth note. Although this discussion has used the competing risk model to offer a ranking of whistle blowing speeds, the order of magnitude for the risk of detection is very comparable across whistle blower groups, other than internal governance mechanism. Also, there is no absolute ordering of whistleblower risk once internal governance fails.

## **5. Did Enron and Sarbanes-Oxley Change the Whistleblowing Environment?**

Our data allow us to ask whether the regulatory environment changed following the backlash to scandals in 2001 and 2002. We first look at the breakdown of whistleblowers for frauds being brought to light before and after the Enron scandal date. We use the date in which the Enron class period ended, October 18, 2001, as the cutoff point for pre- and post-Enron periods. Although the cutoff is set by the Enron scandal, we believe that this cutoff point is equally important as marking the demise of Arthur Andersen, potentially a key event for an awakening of gatekeepers and regulators.

The second split of our data divides pre- and post-Sarbanes Oxley (SOx) periods. We chose the cutoff point for the change in environment following Sarbanes-Oxley as

August 29, 2002, the date at which Sarbenes-Oxley went into effect. One might argue that firms began to comply with the provisions of Sarbenes-Oxley months before this date, but we chose the August, 2002 date as a moment when all of their preparation would have to be revealed to the public through financial statement certification.

We are interested in asking whether these shifts in environments changed the incentives for and attention to whistleblowing for the different actors. Table 9 shows the distribution of whistleblowers by the Enron and SOx splits. Of the 243 cases, there are 126 pre-Enron/Arthur Andersen and 117 after. Not surprisingly, nearly 50 frauds came to light between October, 2001 and August, 2002, resulting in 174 pre-SOx frauds and 69 post-SOx cases.

Table 9 highlights three observations. First, the role of auditors drastically changed following Enron/Arthur Andersen. The whistleblowing of auditors increased from 6.3% pre-Enron to 15% post-Enron. The data suggest that this trend was reinforced by SOx. Following SOx auditors blew the whistle in 22% of the cases. A bit of caution must be observed in interpreting these results too strongly. The demise of Arthur Andersen brought a massive change in auditors. New auditors have a greater incentive to “clean house” with respect to any accounting practices that might be deemed circumspect.

The second observation from Table 9 is that the SEC came to life following the Enron scandal. Whereas from 1996 to 2001, we only find one case of the SEC being the whistleblower, post-Enron the SEC discovered 7 (6%) fraud cases. The SEC awakening seems to have been instigated by the Enron/Arthur Andersen scandals and not by SOx. The likelihood that the SEC is the whistleblower is no larger post-SOx than post-Enron. Industry regulators also increased their role in whistleblowing, from 11% pre-Enron to 19% post-Enron.

The third observation from Table 9 is that the firm is no longer the dominant whistleblower after Enron. Other players discover the frauds before the firm is forced to blow the whistle on themselves. Likewise, the media and analysts’ role as whistleblowers diminished with increased competition from other whistleblowers (e.g., regulators and auditors) with greater access to firm information.

## 6. Conclusions

Much of the literature in corporate governance emphasizes the role of securities regulators (Glaeser et al., 2000) or private enforcement (La Porta et al., 2003) as primary mechanisms to protect shareholders. Our analysis suggests that if we focus on the discovery process, neither channel seems to be important. Derivative suits and the SEC have only a very minor role in the discovery process. By contrast, analysts, employees, and newspapers seem to play a much bigger (and not properly emphasized) role. Of course, securities regulators and private enforcement are not useless as governance institutions. They play an important role in shaping the magnitude of penalties, once corporate frauds are discovered. Nevertheless, no penalty can be assessed until the impropriety is brought to light. Hence, we establish that non-traditional mechanisms such as analysts, employees, and newspapers are at least as important (if not more) than the ones emphasized in the literature.

Our findings also suggest how difficult it is to export the U.S. system of corporate governance abroad. Even in the best of systems, internal governance fails to expose the majority of frauds. Furthermore, the failures of internal mechanisms cannot be solved by simply introducing derivative suits or copying the SEC. An effective corporate governance system relies on a complex web of mechanisms that complement each other. Reproducing such a myriad in other countries is more difficult than copy a single institution.

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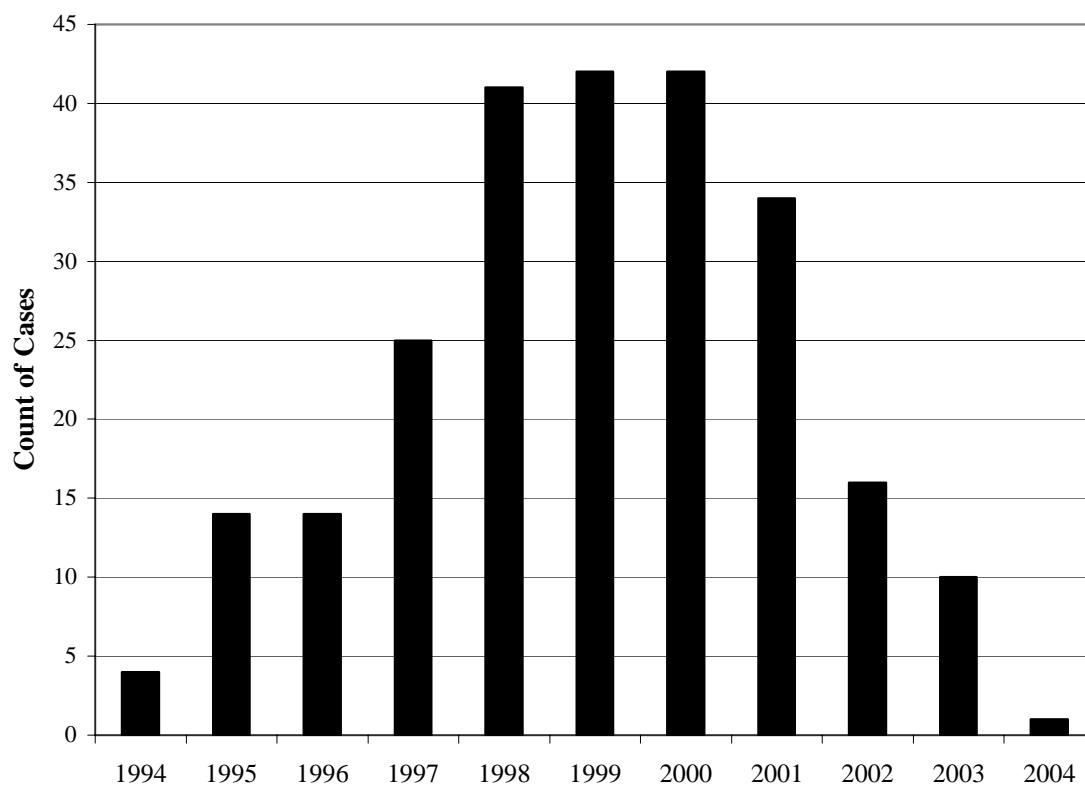
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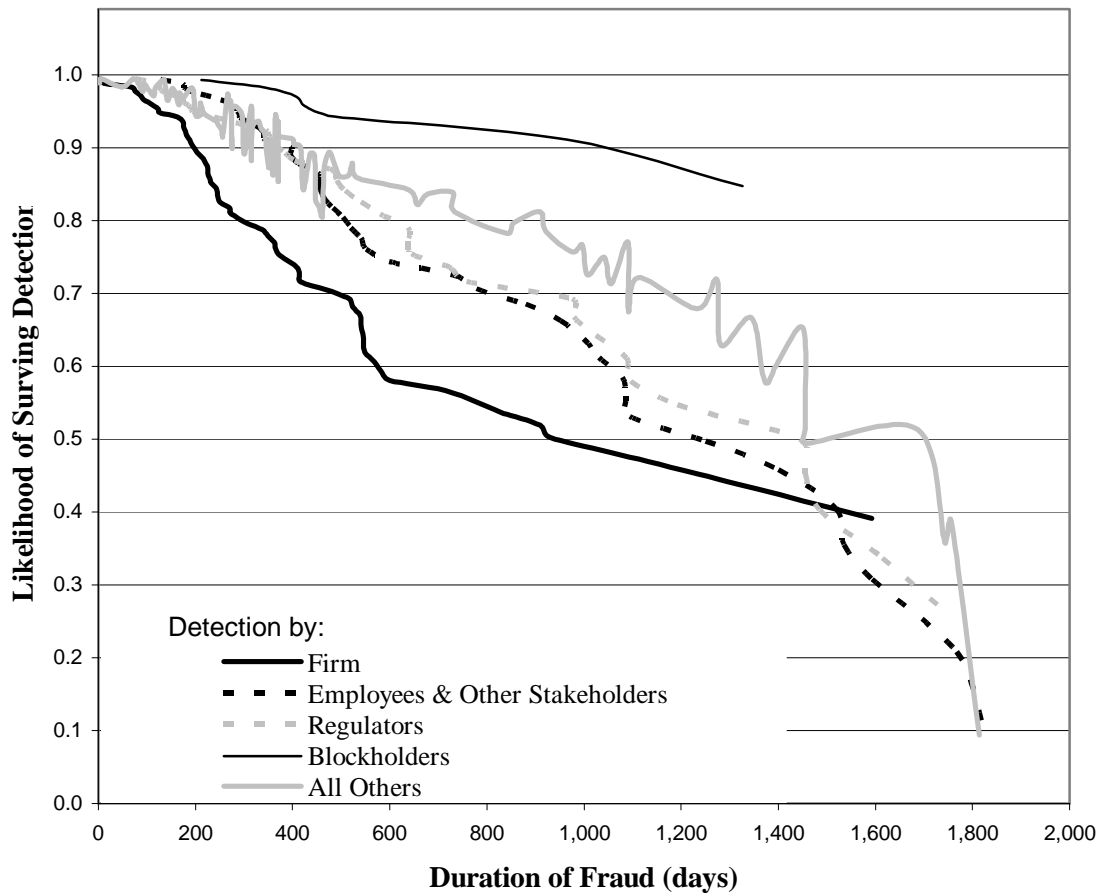
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**Figure 1: Fraud by Starting Year**

This figure identifies the observations in our sample by the date of the start of the fraud. The observations include all those cases in the Stanford Class Action Database that involve firms with more than \$750 million in assets in the year before the end of the class period and where the case is not dismissed or settles for more than \$2.5 million. The start date for the fraud is defined as the beginning date in the class-action lawsuit.



**Figure 2: Hazard of Being Detected by Whistleblowers**

This figure, based on the estimation results from Table 9, shows the probability of escaping detection given the duration of the fraud. A lower line at a specific duration indicates that category of whistleblower is more likely to have detected the fraud. For example, for a fraud of 400 day duration, actors in the firm (the lowest line) are the most likely whistleblower and blockholders (the highest line) are the least likely.

**Table 1: What Are the Alleged Improprieties?**

This table breaks down the observations in the sample by the type of impropriety identified in the class action lawsuit. The categories include illegal self-dealing or insider trading, other allegations of illegal activities, misrepresentation on financial statements/ having improper controls, and failure to disclose operational problems.

<i>Category</i>	<i>Count</i>	<i>Relative Frequency</i>	<i>Duration (days)</i>	<i>Settlement (\$ million)</i>
<b>Illegal Activities</b>	37	(15.2%)	745	45.6
<i>Engagement in Self-Dealing or Insider Trading</i>	12	(4.9%)	902	27.0
<i>Engagement in Other Illegal Activities (Compliance, Price Fixing, Covenant Breaches, Tax Liabilities, etc)</i>	25	(10.3%)	670	54.5
<b>Misrepresentation on Financial Statements or Breach of Having Proper Controls</b>	162	(66.7%)	595	197.3
<b>Failure to Disclose Operational Problems (Production, Client, Acquisitions, R&amp;D, etc)</b>	44	(18.1%)	402	42.7
<b>Total Average</b>	<b>243</b>		<b>583</b>	<b>146.2</b>

**Table 2: What Are the Likely Motives of the Alleged Fraud?**

This table breaks down the observations in our sample by motives of the responsible party. Since motives are not directly observable we impute likely motives from an extensive reading of the onset and development of the fraud in news accounts, lawsuit testimony (where available), SEC findings (where available) and other sources described in the text. Each category is based on a richer initial categorization. For example, we classified organic growth as a motive where the onset and development of the fraud were associated with capital raising either through equity (initial public offering or seasoned equity offering) or debt (bank financing or public debt issuance). We have organized motives from those most objectionable from a governance perspective (e.g. personal profit at the top of the table) to those less objectionable (e.g. firm value enhancement at the bottom of the table).

<i>Category</i>	<i>Count</i>	<i>Relative Frequency</i>	<i>Duration (days)</i>	<i>Settlement (\$ million)</i>
Personal Profit				
Examples: Self-dealing to privately owned subsidiaries, using firm collateral for personal loans, insider trading	40	(16.5%)	648	363.4
Selling off Shares, Division or Firm				
Examples: Inflating expectations on asset value for spin off, inflating firm value for blockholder to disgorge position or for firm sale	18	(7.4%)	353	23.6
Merger/Acquisition				
Examples: Inflating expectation of acquisition, denying failures of mergers	51	(21.0%)	523	163.7
Organic Growth				
Examples: Inflating expectations on R&D or Investments	49	(20.2%)	595	50.2
Industry Downturn				
Examples: Inflating expectations of firm's ability and position to withstand downturns	26	(10.7%)	406	99.6
Smoothing Earnings				
Examples: Hiding asset overvaluation or debt understatement until firm condition improves to take charges	36	(14.8%)	637	79.1
Firm Value Enhancement				
Examples: Price fixing, avoiding costly industry regulations, overcharging	19	(7.8%)	870	87.1
Unknown	4	(1.6%)	900	13.0
<b>Total Average</b>	<b>243</b>		<b>583</b>	<b>146.2</b>



**Table 3: Who Blows the Whistle on the Alleged Fraud?**

This table breaks down observations in our sample by the identity of the whistleblower whose actions brought the fraud to light. This table organizes the whistleblower by the ‘distance’ from the firm, with whistleblowers at the top of the table being closer to the firm and those at the bottom being furthest from the firm. We describe our procedure for identifying whistleblowers in the text.

<i>Whistleblower Distance Category</i>	<i>Specific Whistleblower</i>	<i>Count</i>	<i>Relative Frequency</i>	<i>Duration (days)</i>	<i>Settlement (\$ million)</i>
Firm	Firm	60	(24.7%)	415	66.4
	<b>Total Firm</b>	<b>60</b>	<b>(24.7%)</b>	<b>415</b>	<b>66.4</b>
Insiders	Board & New Management	16	(6.6%)	616	134.8
	Officers	5	(2.1%)	963	218.0
	<b>Total Insiders</b>	<b>21</b>	<b>(8.6%)</b>	<b>699</b>	<b>155.6</b>
Blockholders	Equity Holders	1	(0.4%)	344	2.5
	Banks	6	(2.5%)	637	36.4
	<b>Total Blockholders</b>	<b>7</b>	<b>(2.9%)</b>	<b>595</b>	<b>29.6</b>
Employees & Other Stakeholders	Employees	29	(11.9%)	398	212.8
	Suppliers	2	(0.8%)	774	--
	Clients	7	(2.9%)	595	23.6
	Competitors	3	(1.2%)	631	5.7
	<b>Total Employees &amp; Other</b>	<b>41</b>	<b>(16.9%)</b>	<b>478</b>	<b>157.7</b>
Professional Service	Auditors	24	(9.9%)	731	113.9
	Insurance	1	(0.4%)	1372	--
	Investment Bankers	--	--	--	--
	<b>Total Prof. Service</b>	<b>25</b>	<b>(10.3%)</b>	<b>756</b>	<b>113.9</b>
Access through Disclosure	Analysts	26	(10.7%)	401	73.7
	Plaintiff Law Firms	2	(0.8%)	956	4.2
	<b>Total Disclosure Access</b>	<b>28</b>	<b>(11.5%)</b>	<b>441</b>	<b>69.4</b>
Media	Newspapers	25	(10.3%)	561	235.1
	<b>Total Media</b>	<b>25</b>	<b>(10.3%)</b>	<b>561</b>	<b>235.1</b>
Regulators	Trade Organization	4	(1.6%)	1085	53.0
	Industry Regulators	18	(7.4%)	420	51.3
	SEC	8	(3.3%)	813	14.1
	Federal Investigators	6	(2.5%)	873	3085.0
	<b>Total Regulators</b>	<b>36</b>	<b>(14.8%)</b>	<b>657</b>	<b>307.1</b>
<b>Total Average</b>		<b>243</b>		<b>583</b>	<b>146.2</b>

**Table 4: What Factors Triggered the Whistleblower Action?**

Whistleblowers are often stimulated to bring the fraud to light at that time by internal or external pressures. This table breaks down the observations by the primary factor that triggered the whistleblower to bring the fraud to light at that time. We first indicate trigger factors that arise from within the firm to divulge information, including a change in auditor, restructuring, financial distress, completion of a financing event, and a negative operations shock. Then we identify trigger factors that arise from outside the firm, including quarterly required earnings announcements, scrutiny from firm-specific investigations and industry investigations prompted by scandal.

<i>Category</i>	<i>Count</i>	<i>Relative Frequency</i>	<i>Duration (days)</i>	<i>Settlement (\$ million)</i>
Negative operations shock				
Loss of clients or contracts, failure of product line, supplier backlog	40	(16.5%)	486	31.2
Restructuring, executive turnover & disputes				
Management turnover, labor or divisional restructuring, labor negotiations	31	(12.8%)	599	155.1
Completion of financing event				
Completion of M&A, IPO or SEO	18	(7.4%)	376	255.4
Change in auditing or control				
Arthur Andersen failure, auditor resignation, new accounting system, merger control integration	16	(6.6%)	888	38.9
Financial distress				
Defaulting on debt service, soliciting distress Financing	11	(4.5%)	517	50.7
<b>Total Internal Forces on Firm to Divulge Information</b>	<b>116</b>	<b>(47.7%)</b>	<b>557</b>	<b>102.0</b>
Earnings announcement, routine procedures & compliance				
Revising forecast, scheduled earnings announcement to analysts, meeting SEC filing requirements, complying with other regulators	44	(18.1%)	520	93.7
Outside scrutiny				
Regulator investigations, target of outside due diligence, newspaper investigations	35	(14.4%)	710	454.3
Scandal fallout				
Increased industry regulator inquiries related to a competitor scandal, increased scrutiny of off-balance sheet entities	17	(7.0%)	822	91.1
<b>Total Outside Extraction of Information</b>	<b>96</b>	<b>(39.5%)</b>	<b>643</b>	<b>224.7</b>
Timing announcements to unrelated shocks				
Large positive or negative event for the firm serving as the central focus of earnings announcements	20	(8.2%)	463	90.5
Unknown	11	(4.5%)	555	36.2
<b>Total Average</b>	<b>243</b>		<b>583</b>	<b>146.2</b>

**Table 5: Estimates of Whistleblower Specialization**

This table examines whether whistleblowers specialize in detecting different types of alleged fraud. The dependent variable of the multinomial logistic regression is the category of whistleblower. The excluded whistleblower category is the firm. The impropriety categories from Table 1 are (i) illegal activities and non-compliance, (ii) misrepresentation on financial statements, and (iii) failure to disclose or misrepresent events, with the last one excluded as the offset. Standard errors are in parentheses, and \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% levels respectively.

<i>Dependent Variable: Category of Whistleblower</i>			
<i>Estimation = Multinomial Logistic</i>			
<i>Offset Whistleblower Category = Firms. Offset Impropriety Category = Failure to Disclose</i>			
Insiders	Constant	-1.050*** (0.25)	-2.303*** (0.74)
	Illegal Activities		2.303 (1.60)
	Misrepresentation on Financial Statements		1.529* (0.80)
Blockholders	Constant	-2.148*** (0.40)	-2.996*** (1.03)
	Illegal Activities		4.094*** (1.55)
	Misrepresentation on Financial Statements		0.431 (1.19)
Employees & Other Stakeholders	Constant	-0.381* (0.20)	-1.204*** (0.47)
	Illegal Activities		3.507*** (1.15)
	Misrepresentation on Financial Statements		0.759 (0.53)
Professional Services	Constant	-0.875*** (0.24)	-2.996*** (1.03)
	Illegal Activities		4.094*** (1.55)
	Misrepresentation on Financial Statements		2.377** (1.06)
Access to Disclosure	Constant	-0.762*** (0.23)	-1.609*** (0.55)
	Illegal Activities		2.708** (1.28)
	Misrepresentation on Financial Statements		0.990 (0.61)
Media	Constant	-0.875*** (0.24)	-1.609*** (0.55)
	Illegal Activities		2.996** (1.25)
	Misrepresentation on Financial Statements		0.779 (0.62)
Regulators	Constant	-0.511** (0.21)	-1.204*** (0.47)
	Illegal Activities		3.689*** (1.14)
	Misrepresentation on Financial Statements		0.431 (0.55)

**Table 6: Effect of Whistleblower, Impropriety and Motive on Settlement**

<b>Dependent Variable: Settlement Amount (\$million)</b>	<b>1</b>	<b>2</b>	<b>3</b>
<i>Whistleblowers (offset = firm)</i>			
Insiders	89.20 (62.25)		
Blockholders	-36.76* (19.79)		
Employees & Other Stakeholders	91.30 (115.73)		
Professional Service	47.53 (85.13)		
Access through Disclosure	3.00 (31.04)		
Media	168.71 (147.25)		
Regulators	240.73 (265.42)		
<i>Improprieties (offset = failure to disclose operational problems)</i>			
Illegal Activities		3.03 (21.64)	
Misrepresentation on Financial Statements		154.56** (71.94)	
<i>Motives for fraud (offset = smoothing earning)</i>			
Personal profit			304.97 (246.13)
Selling off Shares, Division or Firm			-49.28** (24.10)
Merger/Acquisition			90.87 (70.46)
Organic Growth			-22.64 (26.20)
Industry Downturn			26.80 (55.20)
Firm Value Enhancement			25.09 (55.83)
Constant	66.39*** (17.25)	42.74*** (7.66)	72.85*** (22.60)
R-squared	0.02	0.02	0.04
Observations	150	150	150

**Table 7: Hazard of Being Caught by Whistleblower, Impropriety and Motive**

<b>Dependent Variable: Duration of Fraud</b>	<b>1</b>	<b>2</b>	<b>3</b>
<i>Whistleblowers (offset = firm)</i>			
Insiders	-0.735*** (0.26)		
Blockholders	-0.361 (0.40)		
Employees & Other Stakeholders	-0.640*** (0.21)		
Professional Service	-0.751*** (0.24)		
Access through Disclosure	-0.039 (0.23)		
Media	-0.309 (0.24)		
Regulators	-0.519** (0.21)		
<i>Improprieties (offset = failure to disclose operational problems)</i>			
Illegal Activities		-0.723*** (0.23)	
Misrepresentation on Financial Statements		-0.515*** (0.17)	
<i>Motives for fraud (offset = smoothing earning)</i>			
Personal profit			-0.088 (0.23)
Selling off Shares, Division or Firm			0.748*** (0.29)
Merger/Acquisition			0.213 (0.22)
Organic Growth			-0.017 (0.22)
Industry Downturn			0.511** (0.26)
Firm Value Enhancement			-0.325 (0.28)
Observations	243	243	241

**Table 8: Competing Risk Model of Fraud Duration**

The estimates are from a competing risk model of the duration of the fraud, where the whistleblowers compete to detect the fraud the quickest. The model estimates coefficients for impropriety categories to control for the variation of fraud duration due to the type of fraud being committed. All variables are categorical. Standard errors are in parentheses, and \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% levels respectively.

<i>Dependent Variable: Detection Rate of Fraud</i>	
<i>Estimation = Competing Risk Model</i>	
Illegal Activities	-0.559* (0.29)
Misrepresentations on Financial Statements	-0.608*** (0.18)
Personal profit	0.248 (0.22)
Selling off Shares, Division or Firm	0.461** (0.23)
Merger/Acquisition	-0.341 (0.29)
Organic Growth	-0.078 (0.30)
Industry Downturn	0.006 (0.24)
Firm Value Enhancement	0.713** (0.29)
Observations	1,897
Robust standard errors in parentheses	
Plot of Hazard by Whistleblower from this estimation shown in Figure 2.	

**Table 9: Whistleblower by Pre- & Post-Enron/Sarbanes Oxley**

<i>Whistleblower Distance Category</i>	<i>Specific Whistleblower</i>	<i>All</i>	<i>Pre-Enron</i>	<i>Post-Enron</i>	<i>Pre-SOX</i>	<i>Post-SOX</i>
Firm	Firm	60	42 (33%)	18 (15%)	49 (28%)	11 (16%)
	<b>Total Firm</b>	<b>60</b>	<b>42 (33%)</b>	<b>18 (15%)</b>	<b>49 (28%)</b>	<b>11 (16%)</b>
Insiders	Board & New Management	16	8 (6.3%)	8 (6.8%)	11 (6.3%)	5 (7.2%)
	Officers	5	2 (1.6%)	3 (2.6%)	2 (1.1%)	3 (4.3%)
	<b>Total Insiders</b>	<b>21</b>	<b>10 (7.9%)</b>	<b>11 (9.4%)</b>	<b>13 (7.5%)</b>	<b>8 (12%)</b>
Blockholders	Equity Holders	1	1 (0.8%)	-- --	1 (0.6%)	-- --
	Banks	6	3 (2.4%)	3 (2.6%)	5 (2.9%)	1 (1.4%)
	<b>Total Blockholder</b>	<b>7</b>	<b>4 (3.2%)</b>	<b>3 (2.6%)</b>	<b>6 (3.4%)</b>	<b>1 (1.4%)</b>
Employees & Oth Stakehold.	Employees	29	5 (4.0%)	2 (1.7%)	6 (3.4%)	1 (1.4%)
	Suppliers	2	3 (2.4%)	0 (0.0%)	3 (1.7%)	-- --
	Clients	7	14 (11%)	15 (13%)	22 (13%)	7 (10%)
	Competitors	3	-- --	2 (1.7%)	-- --	2 (2.9%)
	<b>Total Emplies &amp; Other Stakehold.</b>	<b>41</b>	<b>22 (18%)</b>	<b>19 (16%)</b>	<b>31 (18%)</b>	<b>10 (15%)</b>
Professional Service	Auditors	24	8 (6.3%)	16 (14%)	9 (5.2%)	15 (22%)
	Insurance	1	0 (0.0%)	1 (0.9%)	0 (0.0%)	1 (1.4%)
	Investment Banker	--	-- --	-- --	-- --	-- --
	<b>Total Prof Service</b>	<b>25</b>	<b>8 (6.3%)</b>	<b>16 (14%)</b>	<b>9 (5.2%)</b>	<b>15 (22%)</b>
Access through Disclosure	Analysts	26	13 (10%)	13 (11%)	20 (12%)	6 (8.7%)
	Plaintiff Law Firms	2	-- --	2 (1.7%)	2 (1.1%)	-- --
	<b>Total Access Disclosure</b>	<b>28</b>	<b>13 (10%)</b>	<b>15 (13%)</b>	<b>22 (13%)</b>	<b>6 (8.7%)</b>
Media	Newspapers	25	13 (10%)	12 (10%)	22 (13%)	3 (4.3%)
	<b>Total Media</b>	<b>25</b>	<b>13 (10%)</b>	<b>12 (10%)</b>	<b>22 (13%)</b>	<b>3 (4.3%)</b>
Regulators	Trade Organizatn	4	2 (1.6%)	4 (3.4%)	3 (1.7%)	3 (4.3%)
	Industry Regulator	18	10 (7.9%)	8 (6.8%)	14 (8.0%)	4 (5.8%)
	SEC	8	1 (0.8%)	7 (6.0%)	4 (2.3%)	4 (5.8%)
	Fed. Investigators	6	1 (0.8%)	3 (2.6%)	1 (0.6%)	3 (4.3%)
	<b>Total Regulators</b>	<b>36</b>	<b>14 (11%)</b>	<b>22 (19%)</b>	<b>22 (13%)</b>	<b>14 (20%)</b>
<b>Total Average</b>		<b>243</b>	<b>126</b>	<b>117</b>	<b>174</b>	<b>69</b>

## APPENDIX: Summaries of Cases (to be completed)

THE INFORMATION PROVIDED HEREUNDER IS PROVIDED "AS IS." Statements of fact and opinion in the article are those of the respective authors. The authors make no representation express or implied in respect of the accuracy of the data in this paper and cannot accept any legal responsibility or liability for any errors or omissions that may be made. The information provided are based upon investigations and not based upon criminal convictions. The Authors, nor any of their agents or representatives, make no warranty or representation regarding the timeliness, content, sequence, accuracy, or completeness of any information or data furnished hereunder [or that the information or data provided hereunder may be relied upon]. The reader should make his/her own evaluation as to the appropriateness or otherwise of the data presented.

### **3Com Corporation 97**

05/23/1997 to 11/05/1997

Whistleblower: Newspaper

Motivation: Merger/Acquisition

Investigative reporting by the San Francisco Chronicle following 3Com's quarterly financials uncovers that not only has 3Com's newly acquired US Robotics division not been in production due to inventory excesses, but short sellers have known that 3Com is channel stuffing. Subsequent New York Times reporting reveals revenue inflation occurring through GAAP pool-of-interests merger rules, resulting in double-counting of profitable ignoring newly acquired US Robotics losses, further hidden by channel stuffing of the distribution lines. An SEC inquiry forces 3Com to revise its accounting methods. 3Com settles the class-action suit for \$259 million.

### **Adelphia Communications**

01/19/2001 to 04/01/2002

Whistleblower: Analyst

Motivation: Personal profit

Analysts become particularly attentive to Adelphia's balance sheet because of a pre-commitment of the controlling Rigas family to buy Adelphia stock at what was then an 80% premium and the failure of a former subsidiary making Adelphia liable for \$500 million. Thus, when the firm announces \$2.3 billion of off-balance sheet co-borrowing agreements with the Rigas and cannot answer analysts' questions as to the assets securing the debt, the whistle is blown that the Rigas family is using co-borrowing to purchase Adelphia stock to fulfill their commitment. The firm restates its earnings for 1999, 2000 and 2001 after deciding to reflect \$1.6 billion in debt on its books and files for bankruptcy one month later. Adelphia pays \$715 million to resolve claims by the SEC and the DOJ. The Rigas family forfeits \$1.5 billion in assets. The firm's auditors Deloitte & Touche resolves SEC charges by paying a \$50million fine. Two members of the Rigas family are found guilty of criminal charges and are serving 15-20 years. This class-action lawsuit has yet to be resolved.

### **Aetna Inc.**

03/06/1997 to 09/29/1997

Whistleblower: Firm

Motivation: Merger/Acquisition

After completing its much-praised merger with U.S.

Healthcare, Aetna issues a series of warnings that it will experience earnings shocks and take charges to cover greater than expected HMO costs, mostly associated with failure to integrate U.S. Healthcare's operations. Aetna restructures the management of claims and control in an effort to control the costs. Management is ousted and Aetna settles for \$82.5 million.

### **Aetna, Inc.**

12/13/2000 to 06/07/2001

Whistleblower: New management

Motivation: Smoothing earnings

Aetna's new management team announces earnings shortfalls are due to problems of control in claims, which have resulted in the firm's not reviewing claims which were rejectable and paying some claims twice. After implementing new procedures and exiting the HMO market in certain States, Aetna settles for \$5 million.

### **AK Steel Holding Corporation**

07/15/1999 to 01/25/2000

Whistleblower: Analyst

Motivation: Merger/Acquisition

A report by Bear Sterns research reveals that AK Steel failed to disclose (i) that it is locked into long-term sales contracts at low 1998-1999 prices and (ii) that a labor strike at a recently-acquired Armco plant substantially raised labor costs in the 4th quarter. Immediately prior to the Bear Sterns report, AK Steel announces that earnings plunged due to rising raw material costs and charges taken for the recent merger with Armco. The Bear Sterns report uncovers that the company would have known the impact of raw materials price increases prior to the stock swap merger with Armco.

### **Allegheny Energy, Inc.**

04/23/2001 to 10/08/2002

Whistleblower: Newspaper

Motivation: Industry Downturn

The New York Times reports that Allegheny's energy trading unit, which it inauspiciously bought from Merrill Lynch in 2001, engaged in round trip trades with Enron. After Allegheny fires and sues a lead trader for self-dealing, it takes a series of charges, endures a series of investigations and loses 90% of its stock value before shutting down the energy trading



unit. Shareholder value was wasted as the value in Allegheny's \$490 million purchase from Merrill was attributable to round trip trades, which were difficult to implement post-Enron. Allegheny settles with shareholders for \$15 million; the firm's case against Merrill is still pending.

#### **Amerco, Inc.**

02/12/1998 to 09/26/2002

Whistleblower: Auditor

Motivation: Personal profit

As Pricewaterhouse Coppers is being replaced by Amerco, parent of U-Haul Trucks, it announces that the firm has material weaknesses in its inventory control, record retention and staffing competency. The outgoing auditor forces the firm to re-state two prior years of earnings, which show less equity and more liabilities on Amerco's books. Amerco's resources were used to buy certain assets which were later sold to entities privately held by the firm's executives for inadequate consideration. Amerco is formally investigated by the SEC, files for bankruptcy and dismisses a number of executives.

#### **America West Holding**

11/19/1997 to 09/03/1998

Whistleblower: Employee

Motivation: Sell Out

Maintenance workers at American Airlines file an unusually high number of FAA Safety Hotline complaints concerning contract labor standards, coinciding with labor negotiations with the firm over the use of outside contract labor. The FAA placing of America West on the Safety Watch List forces the firm to admit maintenance deficiencies and incur expenses to amelioration, reversing their claims that increased FAA inspections following ValuJet's crash were simply routine. In the interim between the initial inspections and the FAA action, America West's controlling equity investor sells off two-thirds of its position in the firm. The FAA levies a \$5 million fine against America West. America West settles the class action suit for \$15 million.

#### **Ann Taylor Stores**

02/03/1994 to 05/04/1995

Whistleblower: Internal unknown

Motivation: SEO

Having obtained information from unknown insiders, class action lawyers disclose the existence of "secret warehouses" in which Ann Taylor conceals non-sellable inventory. The lawyers become interested in the firm, presumably, after a series of missed earnings targets and forecasted losses. During the class period, the firm issues equity to alleviate its debt burden and to cash out its primary shareholder, Merrill Lynch. Ann Taylor settles for \$3.3 million, net of insurance.

#### **AOL Time Warner, Inc.**

01/27/1999 to 07/24/2002

Whistleblower: Newspaper

Motivation: Merger/Acquisition

Immediately following the announced merger of AOL and Time Warner, the New York Times and, especially, the Washington Post assert that AOL's accounting is aggressive, particularly in its booking of advertising revenue. The Washington Post correctly reports that AOL had been booking as revenue bartered advertising with other firms and full round-trip transactions. Insiders sold tens of thousands of shares during the price run-up prior to the merger. SEC and DOJ investigations result in \$400 million in re-statements of revenue and a \$510 million fine. Shareholder suits settle for \$2.4 billion.

#### **Aon Corporation**

05/04/1999 to 08/08/2002

Whistleblower: SEC

Motivation: SpinOff

In seeking SEC for approval of a spin-off, Aon finds its accounts the subject of SEC scrutiny, resulting in a need to re-state earnings related to allowances for reinsurance from the September 11, 2001 attacks. The SEC presumably carefully inquires into Aon's accounting control due to its frequent restructurings, spin-offs and use of special purpose entities, according to a Merrill Lynch insurance analyst. Aon takes prior years earnings charges of \$50 million and writes off \$90 million in uncollectible reinsurance. Aon settles shareholder suits for \$7.3 million.

#### **AppOnline.com, Inc.**

06/01/1999 to 06/30/2000

Whistleblower: Client

Motivation: Personal profit

After over 150 complaints by clients of AppOnline are reported to various State regulators, the New York State Banking Department suspends the firm's license to issue mortgages. The firm had been canceling checks after closings such that the mortgage would default while still generating fees to AppOnline. AppOnline files for bankruptcy days later. The executives and relatives plead guilty to wire fraud, securities fraud and money laundering.

#### **Apria Healthcare**

03/02/1995 to 12/31/1998

Whistleblower: Employee

Motivation: Value Enhancement

Fortune Magazine reports Apria's integration issues with hundreds of computer systems from its branches and plethora of recent acquirers. Specifically, the firm's billing system often fails to bill or incorrectly bills customers resulting in questions whether the accounts receivable are collectible. Following the

article, Apria reveals a new plan to reorganize systems management, and retains Goldman Sachs to explore strategic options. Apria announces it will take a charge to write down the value of internally developed software and bad debt. The firm fires its CEO, president and CFO. In combination with a Medicare fraud class action suit, Apria settles the shareholder suit for \$42 million.

#### **Apria Healthcare**

03/02/1995 to 12/31/1998

Whistleblower: Newspaper

Motivation: Merger/Acquisition

Apria branch manager Mark Parker informs the Justice Department of Apria's use of kickbacks payments to generate business eventually billed to Medicare. Apria settles this qui tam case with Parker and the DOJ for \$2 million. Apria settles the class action suit, in combination with shareholders suit concerning Apria's poor control systems, for \$42 million.

#### **Ascend Communications, Inc.**

11/05/1996 to 09/30/1997

Whistleblower: Newspaper

Motivation: Merger/Acquisition

Following the announcement by Ascend forecasting its new product rollout in time to beat the competition, the San Francisco Chronicle publishes an article questioning Ascend's ability to meet the deadline with a workable product. During the implementation period, Ascend executives sell stock valued over \$40 million and consummate a merger with Cascade Communication. The class period ends when Ascend releases earnings sharply below estimates due to significant product delays and glitches. Ascend settles the subsequent class action suit for \$5.45 million.

#### **AT&T Corporation**

10/25/1999 to 05/01/2000

Whistleblower: Firm

Motivation: SpinOff

AT&T fails to report that its core businesses -- long distance and business services -- are being hurt by wireless technology and by changes implemented at AT&T, particularly in reference to attrition resulting from a joint venture with Concert PLC. AT&T loses two large clients, an arm of the U.S. government and B.P., which trigger the release of revenue shortfall to the public in the earnings announcement process. In the class period, AT&T issues a \$13 billion initial offering of tracking stock on its wireless business. AT&T settles for \$100 million.

#### **Bally Total Fitness Holding Corporation**

08/03/1999 to 04/28/2004

Whistleblower: Auditor

Motivation:

Immediately prior to internal auditor Ernst & Young's resignation, Bally announces that it will take a \$675 million charge for overly-aggressive, GAAP non-compliant revenue recognition and will re-state \$43 million of prior earnings for non-obligatory prepaid membership dues. The resignation of the CEO and an SEC investigation follow the auditor resignation.

#### **Bank One Corporation**

10/02/1998 to 11/10/1999

Whistleblower: Industry regulator

Motivation: Merger/Acquisition

By imposing late fees and penalties on payments to its First USA credit card without proper controls in posting payments, Bank One induces high attrition and generates massive numbers of complaints to the Office of Comptroller of the Currency. The Comptroller's office, with pressure even from members of Congress, forces the firm to disclose its troubled credit card operations and revise its earnings downward. The internal pressure of the after a shakeup of the board and a \$725 million restructuring charge, Bank One settles for \$120 million.

#### **BankAmerica Corporation**

10/01/1998 to 10/13/1998

Whistleblower: Firm

Motivation: Merger/Acquisition

BankAmerica announces that it is writing down \$372 million in lending to D.E. Shaw for the hedge funds' highly leveraged exposure to the Russian bond default. Although BankAmerica had known of its exposure during the period of the Russian shock and Long Term Capital Management collapse, it fails to reveal the extent of lending to D.E. Shaw or the exposure of D.E. Shaw to the shock, focusing instead on its meg-merger with NationsBank. BankAmerica takes over \$20 billion in D.E. Shaw's bond portfolio, which continues to generate losses for the bank as do yet outstanding loans to the hedge fund. BankAmerica settles for \$490 million.

#### **Bausch & Lomb, Inc.**

01/27/2000 to 08/24/2000

Whistleblower: Newspaper

Motivation: Smoothing earnings

A Business Week article uncovers product line stagnation in Bausch & Lomb's core lens care products business. The Business Week attention follows an announcement by the firm that it would miss earnings expectations with short-term weak sales. The firm had not yet admitted that its core product revenues were being eroded by competition and that new product developments were unsuccessful; the failing nature of both sectors allegedly had been known by the firm for most of the year. During the class period, Bausch and Lomb actively invests in new

product R&D and explores opportunities for acquisitions through which it can market the new business lines to generate successes in failing endeavors. The firm settles for \$12.5 million.

#### **BellSouth Corporation**

11/07/2000 to 02/19/2003

Whistleblower: Firm

Motivation: Industry Downturn

In the environment of post-WorldCom turmoil in telecommunications, BellSouth announces that it is experiencing nearly worldwide earnings shortfalls. The last item on BellSouth's newswire is a charge of \$168 million for uncollectible accounts receivable. BellSouth had been performing services for customers who were never billed ('phantom customers'). A change in accounting procedures results in an additional charge of \$500 million.

#### **Belo Corporation**

05/12/2003 to 08/06/2004

Whistleblower: Supplier

Motivation: Personal profit

Belo had been inflating circulation numbers for the Dallas Morning News. The impropriety increases the revenue billed to advertisers, whose fees depend upon audience reached. The fraud is discovered when a contractor informs management that contractors, who are responsible to count and report circulation, are encouraged to inflate circulation figures since they are paid on area circulation figures. Belo repays clients and fires regional management; the SEC commences an investigation.

#### **Bristol Myers Squibb Company**

03/22/2001 to 03/20/2002

Whistleblower: Firm

Motivation: Smoothing earnings

After calling its new drug Vanlev "the most important drug in the pipeline", Bristol Myers withdraws its FDA application when it discovers in its clinical trial results that Vanlev has potentially deadly side-effects to the throat. The announcement of withdrawing the application was made in March, 2002 when the clinical trial results were available to Bristol Myers in September of the prior year. Additionally, the firm knew that Vanlev's trials aimed at reducing hypertension were not stronger than an existing, cheaper drug already on the market.

#### **Bristol Myers Squibb Company**

09/09/2001 to 01/04/2001

Whistleblower: Newspaper

Motivation: Merger/Acquisition

The Cancer Letter, a research newspaper, obtains a copy of the FDA's letter to Bristol Myers saying that they refused to consider the application for approval of

Erbitux, a cancer drug being developed in a financing arrangement between Bristol Myers and ImClone. Bristol Myers, while coining Erbitux as a blockbuster, had failed to reveal that the clinical trials were inconclusive due to problems in the trial structure and that they had known that the FDA would not consider the application in that they understood the inconclusiveness of the outcome. A series of FDA, SEC, DOJ and Congressional investigations ensue, primarily aimed at ImClone. Bristol Myers writes off \$735 million of the ImClone investment and forces a change in management at ImClone.

#### **Bristol Myers Squibb Company**

10/19/1999 to 03/10/2003

Whistleblower: Firm

Motivation: Smoothing earnings

Bristol Myers announces that revenues for the current period would not meet expectations because of an inventory glut associated with channel stuffing its distribution line in prior periods. The firm was shedding excess inventory and propping up earnings by offering inducements to wholesalers to buy product for future demand. Bristol Myers re-states 1999-2002 earnings by \$2.75 billion. The firm settles with the SEC for \$150 million and with shareholders for \$300 million.

#### **Campbell Soup Company**

11/18/1997 to 01/08/1999

Whistleblower: Firm

Motivation: Smoothing earnings

In revealing that its supply chain management needed restructuring, Campbell discloses that it had been channel-stuffing its supply line to meet quarterly revenue expectations. The internal pressure to restructure its supply logistics to achieve future cost-savings forces the information to light. Campbell settles for \$35 million.

#### **Cardinal Health, Inc.**

10/24/2000 to 06/30/2004

Whistleblower: Newspaper

Motivation: Smoothing earnings

The Wall Street Journal reports that Cardinal Health has recorded \$22 million from a settlement with its supplier as operational profit in the current period, without which Cardinal would have missed earnings forecasts. As a result of the media attention, the SEC commences an informal inquiry and then a formal investigation into Cardinal's practice of booking revenues and expense. The firm has been deliberately manipulating inventory processes such that it could classify bulk pass-through shipments as operational revenue. The firm re-states three years of earnings and fires its CFO.

**Cendant Corporation**

05/28/1997 to 04/15/1998

Whistleblower: Employee

Motivation: Personal profit

When integrating with newly acquired partner CUC, Cendant's accounting staff discover irregularities that eventually are tabulated to be \$500 million in false revenues stated by CUC. Criminal investigations later find the executives of CUC guilty of accounting fraud undertaken for personal profit. Cendant settles for \$2.85 billion.

**Cephalon, Inc.**

06/12/1995 to 06/07/1996

Whistleblower: Industry regulator

Motivation: SEO

Cephalon's announces that the European clinical trial of Myotrophin confirm the success of the drug on reducing the speed of Lou Gerig's disease as found in a previous round of North American trials. The FDA's study of the results, however, reveals that the mortality rate of treated patients was nearly twice that of patients taking a placebo. During the trials, Cephalon issues 3.3 million new shares, and insiders trade on their shares, an act for which they are later indicted by the SEC. The FDA denies approval of Myotrophin. Cephalon settles for \$17 million.

**Ceridian Corporation**

01/23/1996 to 08/26/1997

Whistleblower: Firm

Motivation: Expansion

Tests of Ceridian's highly anticipated payroll software product during summer 1997 uncover difficulties in processing speeds and higher-than-expected installation costs, both of which were known to the firm prior to its disclosure. Ceridian announces concurrently that it is selling its defense electronics unit and halting development on its major software project, resulting in a \$150 million charge. Ceridian settles for \$5.2 million.

**Ceridian Corporation**

04/17/2003 to 07/19/2004

Whistleblower: Employee

Motivation:

An employee of Ceridian raises concerns of capitalization and expensing of assets in the firm's Human Resource Solutions business. The firm delays its earnings announcement and eventually removes \$60 million off earnings from 1999-2003 for failure to expense the capitalization of assets. The company's problems with asset control are systematic; the SEC had just ended a prior investigation of similar concerns in a different Ceridian division.

**Cigna Corporation**

05/02/2001 to 10/24/2002

Whistleblower: Firm

Motivation: Industry Downturn

Contrary to Cigna's claims that its operating income would not be materially affected by its discontinued reinsurance division, the firm announces over the course of two months that it will take over \$1 billion in charges to cover re-insurance obligations related to minimum death benefits and workman's compensation. During the class period, Cigna raises \$250 million in new equity. The announcements arise out of Cigna's closing of its re-insurance business, which once captured 50-80% of the market. Cigna not only failed to disclose its exposure but also failed to undertake standard hedges common for insurance business.

**Cisco Systems**

08/10/1999 to 02/06/2001

Whistleblower: Firm

Motivation: Industry Downturn

A Network World report, picked up by the San Francisco Chronicle, says that Cisco's previously-admitted inventory problems are inhibiting the shipment of key products. Two weeks later Cisco's management, who have maintained bullish growth projections, report earnings below estimates. In the class period, the firm uses its stock in numerous acquisitions and at the same time has fails to write off uncollectible finance receivables and ships incomplete and faulty product to buy time with its clients. The firm reports a \$2.69 billion loss after taking a \$2.2 billion charge to write down inventory. The class-action lawsuit has yet to be resolved.

**CMS Energy Corporation**

08/03/2000 to 05/10/2002

Whistleblower: SEC

Motivation: Expansion

Post-Enron investigations by the SEC uncover round-trip trades made by CMS. In one year, round trip trades accounted for \$4.4 billion, 98% of CMS's revenue. Investors were misled not only to the value of CMS, but also as to the liquidity of the wholesale electric market. CMS restates earnings for two year, and the SEC charges CMS and three executives. CMS settles with shareholders for \$12 million.

**Coca-Cola Company**

10/21/1999 to 03/06/2000

Whistleblower: Board

Motivation: Smoothing earnings

Coca-Cola's board expedites the transfer of power from Douglas Ivester to Douglas Daft, citing a loss of confidence in Ivester. While taking restructuring charges and announcing new lower growth targets,

new management reveals that Coke has been channel stuffing the supply of formula to bottlers to meet earnings targets. Coca-Cola settles for \$14 million.

#### **Coeur D'Alene Mines Corporation**

01/09/1995 to 07/11/1996

Whistleblower: Firm

Motivation: Expansion

Coeur D'Alene reveals that its Chile gold mine would not commence operations in the present year and that it's recently-acquired New Zealand mine would be closed, both admissions reflecting readily observable operations. The firm had previously stated that both sites were operating according to or below budget. Coeur D'Alene writes down impaired assets in Chile and takes a loss on New Zealand operations while suing the previous owner. The firm settles with shareholders for \$13 million, \$6 of which is obtained from the settlement with the New Zealand seller of the mine.

#### **Cole National Corporation**

01/31/1998 to 05/16/2003

Whistleblower: Auditor

Motivation: Bank Financing/Public Debt  
Issuance

In Deloitte & Touche's initial audit after assuming the account from failing Arthur Andersen, Deloitte suggests that Cole should spread its warranty revenue over the length of the contracts. Cole announces that it will restate earnings from the past five years, as a result of the revenue recognition changes. Following the announcement, the SEC commences an informal inquiry into Cole's previous accounting methods. Cole settles the shareholder suit for \$5.3 million.

#### **Columbia HCA Healthcare Corporation**

04/08/1994 to 09/09/1997

Whistleblower: Employee

Motivation: Value Enhancement

After a number of qui tam whistleblower suits are filed against Columbia, the largest healthcare provider in the county, federal agencies begin an investigation that results in raids on a number of the hospitals. Columbia, which is also Medicare's largest biller, provided financial incentives for doctors to admit more patients, inflate billing record, and to 'upcode' the treatments by performing and billing Medicare for more serious treatments than is deemed necessary. The firm and executives are indicted for criminal Medicare fraud. Columbia repays the government \$250 million.

#### **Comerica Incorporated**

07/17/2002 to 10/01/2002

Whistleblower: Industry regulator

Motivation: Industry Downturn

An examination by Federal Reserve regulators results

in Comerica restating earnings and taking a \$328 million charge to reflect over-valuation of assets in its Munder money management division. Comerica settles on SEC charges that it did not establish adequate loan-loss reserves as a result of poor controls. Comerica settles the class action suit for \$15 million.

#### **Commerce Bancorp, Inc.**

06/01/2002 to 06/28/2004

Whistleblower: Federal investigative agencies

Motivation: Value Enhancement

The FBI reveals that the treasurer's office of City of Philadelphia and Commerce Bancorp had a quid pro quo arrangement in which Commerce make political contributions and extended favorable loans to treasury officials in exchange for banking business of the City. Commerce exits part of the lucrative municipal bond business. Bank executives and city officials are convicted of criminal conspiracy.

#### **Compaq Computer**

07/10/1997 to 03/06/1998

Whistleblower: Analyst

Motivation: Smoothing earnings

Following the trail of a Compaq warning that the price wars are stiffening market share competition, industry analysts discover that Compaq has been channel stuffing to boost short-term revenues. Compaq soon thereafter announces an inventory over-supply problem, and responds with efforts to cut inventory levels. Shareholder suits settle for \$28.6 million.

#### **Computer Associates International, Inc.**

02/27/1998 to 02/25/2002

Whistleblower: Newspaper

Motivation: Personal profit

After Computer Associates announces that it is changing its revenue recognition process to spread sales over the life of projects, the New York Times reports that the firm's announcement and changes are an attempt to mask its improprieties. The NYT covers the firm's layoff disguised as performance firings (to avoid severance pay) and its use of a host of accounting tricks including (i) having 35 days in the last month of the quarter, (ii) re-rolling customer contracts to book further extended revenue, even at the expense of offering software free to induce contracting, and (iii) acquiring other firms with a customer base for the sole purpose of implementing a re-rolling opportunity to book revenue. After unsuccessfully trying to pay themselves \$1.1 billion in promised pay and being forced to return the compensation by shareholder suits, the executives of the firm are indicted for criminal fraud. The firm settles for \$144 million.

**Computron Software, Inc.**

08/24/1995 to 04/01/1996

Whistleblower: Firm

Motivation: IPO

Shortly after its IPO is completed, Computron restates earnings going back 5 years. A subsequent SEC investigation reveals that Computron inflated 3 years earnings prior to its IPO by mis-dating contracts, creating duplicate contracts and using side letters to hide services provided to customers. Arthur Anderson settles for \$3.5 million for its role in the accounting mis-statements, and Computron for \$15 million.

**ConAgra Foods, Inc.**

08/28/1998 to 05/23/2001

Whistleblower: Internal unknown

Motivation: None

In altering its internal control systems to meet compliance with the new SEC regulation SAB101, ConAgra discovers that a division has been booking sales at the contract date but not offsetting revenues when the customers delayed or did not take delivery. The division falsely boosted company earnings by \$120 million. ConAgra's board instigates a full internal audit and shortly thereafter releases the information to the SEC and to analysts. ConAgra settles for \$14 million.

**Crompton Corporation**

10/26/1998 to 10/08/2002

Whistleblower: Federal investigative agencies

Motivation: Value Enhancement

U.S. And E.U. antitrust authorities open investigations into price fixing on five products manufactured by Crompton. Crompton cooperates with the agencies and thus is granted immunity against most criminal charges; however, much of the value of the firm has arisen from unsustainable fixed prices. Two executives are indicted. The firm pays antitrust penalties of \$50 million and begins to settle with consumer class actions groups.

**CVS Corporation**

02/06/2001 to 10/30/2001

Whistleblower: Analyst

Motivation: Bank Financing/Public Debt Issuance

CVS continues to expand rapidly without revealing that a nationwide shortage in pharmacists is causing customer attrition from service delays. Credit Swiss First Boston analysts, concerned with increasing competition in the industry, conduct a survey of pharmacies and uncover a slowdown in prescription processing due to staffing problems. CVS scales back

expansion, closes some stores and settles for \$110 million.

**Dollar General Corp**

03/05/1997 to 01/14/2002

Whistleblower: Firm

Motivation: SEO

Following the resignation of the CFO, Dollar General reveals that it has incorrectly accounted for property leases and tax liabilities. The new CFO and new auditors conduct investigations, resulting in a restatement of earnings downward for 1998 through 2000 by \$100 million. An SEC investigation into its accounting practices is settled for \$10 million. Dollar General settles the class-action lawsuit for \$162 million.

**DPL, Inc.**

03/30/1999 to 08/14/2002

Whistleblower: Auditor

Motivation: Smoothing earnings

At the insistence of Pricewaterhouse Coopers, DPL reveals that it has placed 25% of its assets in a portfolio of investment, some of which is invested abroad. The announcement comes as the energy firm takes a charge of \$1 billion to write off impaired portfolio assets in Latin America. Up until that point, investors did not know DPL has a Latin American portfolio. The CEO resigns, and DPL settles for \$110 million.

**Dynegy, Inc.**

06/21/2001 to 07/22/2002

Whistleblower: Employee

Motivation: Value Enhancement

After Dynegy fails to promote management trainee Ted Beatty, he quits the firm and takes with him documentation about a fraudulent tax-avoidance, cash flow enhancing scheme (Project Alpha) used by Dynegy with its special purpose entities. The Wall Street Journal reports a front-page article based on Beatty's documents. At the same time, Dynegy is being investigated by the SEC and energy regulator for round trip energy trading. The added scrutiny uncovers a final impropriety regarding the use of another special purpose entity (Catlin) to hide debt obligations and shift collateral to new debt. After turning over management and filing for bankruptcy, Dynegy settles for \$468 million, only \$150 of which is covered by insurance.

**E.W. Blanch Holdings**

10/19/1999 to 03/20/2000

Whistleblower: Newspaper

Motivation: Industry Downturn

Although a full quarter earlier analysts predict that E.W. Blanch will lose revenue to an industry-wide

shock in re-insuring workers' compensation, the market does not incorporate the magnitude of the information until the WSJ predicts that Blanch will face earnings surprises after a competitor warns on earnings. Blanch CEO denies future revenue shortfalls as close as two weeks before the earnings shock, but meanwhile has taken a hedge position against his personal stock and, together with other executives, sold \$25 million in stock. The firm is sold to a UK-based reinsurance broker.

### **EEX Corporation**

08/03/1995 to 08/05/1997

Whistleblower: New management

Motivation: Merger/Acquisition

New management from acquirer Texas Utilities takes over managing Ensearch prior to the closing of the two firm's merger and reveals on the day of the merger that the oil and natural gas reserve estimates in Ensearch's EEX division need to be adjusted downward by 45%. Former Ensearch shareholders had agreed to receive 0.225 of Texas Utilities stock plus 1.5 shares of EEX stock, an entity which is being spun off at the merger. EEX settles for \$25 million.

### **El Paso Corporation**

01/29/2001 to 05/29/2002

Whistleblower: Equity holder

Motivation: Bank Financing/Public Debt  
Issuance

Oscar Wyatt, a large equity holder whose firm Coastal was recently acquired by El Paso, makes a public statement concerning El Paso's hiding of debt in special purpose entities to avoid any balance sheet impact and to bypass the board in decision making. Of particular concern was El Paso's issuance of \$830 worth of debt in an off balance sheet deal with Credit Suisse First Boston. In addition, EL Paso committed themselves to long-term contracts such that the marking-to-market of trades could be booked as current revenue. The SEC initiates an investigation into El Paso's booking of hundred of millions of dollars of revenue from such contracts.

### **El Paso Corporation**

02/22/2000 to 02/17/2004

Whistleblower: Federal investigative agencies

Motivation: Smoothing earnings

The Houston U.S. Attorney General's office, while investigating allegations of wash trades and round tripping, discovers problems in the firm's hedge accounting. El Paso had entered into contracts via their merchant energy unit to hedge their natural gas risk. However, after selling the contracts to outside counterparties, the merchant energy group entered into

separate contracts which offset the hedge position. El Paso takes a \$1 billion charge to ameliorate the accounting errors associated with the lack of hedge position.

### **El Paso Corporation**

02/22/2000 to 02/17/2004

Whistleblower: New management

Motivation: Bank Financing/Public Debt  
Issuance

El Paso's new management switches reservoir engineers and contracts for a new audit of oil and natural gas reserves in light of the SEC's increased scrutiny of competitors' reserves. The audit reveals the need to adjust reserves downward by 41%, to take a \$2.6 charge and to restate four years of earnings. The SEC launches a formal investigation.

### **El Paso Electric Company**

02/14/2000 to 10/21/2002

Whistleblower: Industry regulator

Motivation: Value Enhancement

The Federal Energy Regulation Commission investigates El Paso in conjunction with Enron and other power providers for its role in inflating prices in the California energy crisis. El Paso colluded with Enron, Enron traders typically manned El Paso's trading desk, to defraud Californians by conducting round trip trades to manipulate prices. El Paso settles with the regulators for \$14 million, with consumer class action groups for \$1.5 billion and with its own shareholders for \$10 million.

### **Electronic Data Systems Corporation**

09/07/1999 to 09/24/2002

Whistleblower: Analyst

Motivation: Value Enhancement

A Merrill Lynch analyst discovers that EDS has placed a bet on its own stock and was incurring a cost of \$225 million to unwind the losing position. This news came a week after EDS's announcement of an 84% reduction in its quarterly earnings which was precipitated by Proctor and Gamble's backing out of a news conference to announce a new contract with EDS. The bet by EDS on its stock came during a period of large client attrition due to the stagnation in the economy. The SEC formally investigates EDS for its treatment and disclosure of its investment portfolio.

### **EMCOR Group, Inc.**

04/09/2003 to 10/02/2003

Whistleblower: Firm

Motivation: Merger/Acquisition

EMCOR fails to disclose that its high margin small contract business was shrinking relative to the low margin public sector work. The contracts acquired from a recent merger exacerbated the trend.

Additionally, the restructuring process was slower than predicted. EMCOR cuts earnings estimates and analysts grade the firm as 'underperform'.

#### **Employee Solutions, Inc.**

11/14/1995 to 03/14/1997

Whistleblower: Newspaper

Motivation: SEO

Financial World Magazine leaks its forthcoming April article questioning Employee Solutions' practice of booking revenue without setting aside adequate reserve for workers' compensation risk. The firm refutes the article's accusations, proposes anti-takeover amendments and then misses earnings forecasts, triggering class action suits. Employee Solutions eventually takes a charge to cover the costs of increasing its workers' compensation reserves. Employee Solutions settles for \$15 million.

#### **Endocare, Inc.**

10/23/2001 to 10/30/2002

Whistleblower: Officer

Motivation: SEO

An executive, who is later fired, informs the board of concerns about the accounting of certain transactions occurring during the period of Endocare's SEO. The board brings in a lawyer, who is later himself investigated by the SEC for the cover-up, to conduct an inquiry into the control deficiencies in recognition of revenues, accounts receivable, and expenses. Endocare's lack of controls cause auditor KPMG to delay filings and then to resign under statements that the financial statements cannot be relied upon. Department of Justice and SEC investigations ensue. The firm under new management settles for \$9 million.

#### **Enron Corporation**

01/18/2000 to 10/18/2001

Whistleblower: Newspaper

Motivation: Personal profit

The Texas version of the Wall Street Journal publishes a story in the fall of 2000 asking whether the profits from companies like Enron are just artifacts of the firms' manipulation of marking assets to market. A few months later, Fortune and the New York Times publish articles questioning the ultimate origin of value in the stock run-up of Enron and covering Enron's incredulous behavior in the California energy crisis, respectively. Meanwhile, following the Texas WSJ article, short sellers begin increased scrutiny of the firm and, in particular, into Enron's financing entities. Not long after the CEO resigns in August 2001, information comes to light that the firm had misrepresented the value of its assets by billions of dollars, and related party transactions were siphoning value from the firm to the benefit of executives. A number of other improprieties emerge. Shareholders

have claimed \$30 billion in damage from now-defunct Enron; litigation continues.

#### **Enterasys Networks, Inc.**

09/26/2001 to 02/01/2002

Whistleblower: Employee

Motivation: Personal profit

A finance executive at Enterasys uncovers documentation showing revenue booked for a \$4 million sales contract from its Asia-Pacific division that was GAAP non-compliant. Subsequent investigations discover revenue over-booked by \$153 million for the 19 month ending September 2001, resulting from what appears to be a systematic personal profit scheme by executives who are then fired. An SEC investigation ensues and is settled. Enterasys settles the class-action suit for \$50 million.

#### **Federal Home Loan Mortgage Corporation (Freddie Mac)**

06/15/1999 to 06/06/2003

Whistleblower: Auditor

Motivation: Smoothing earnings

Pricewaterhouse Coopers, taking over the Freddie Mac account from failing Arthur Andersen, instructs the firm to reclassify investment income from assets Freddie incorrectly treated as hedge positions and thus to re-state upwards two years of earnings. A resulting accounting probe results in the firing of the three top executives, one of them for altering financial diaries provided to the audit committee. Multiple types of federal civil and criminal investigations as well as Congressional hearing soon follow resulting in evidence that the company used improper internal controls to smooth earnings.

#### **Ferro Corporation**

10/28/2003 to 07/22/2004

Whistleblower: Auditor

Motivation: Smoothing earnings

After a routine closing of the books, the firm announces that its auditors have discovered improper accounting in its polymer division. A divisional employee made improper entries, resulting in the need to take a charge in the current period and, later, to restate two prior years' earnings.

#### **Fifth Third Bancorp**

09/21/2001 to 01/31/2003

Whistleblower: Auditor

Motivation: Merger/Acquisition

After completing its acquisition of Old Kent Financial, Fifth Third's internal and external auditors discover \$54 million in treasuries bonds and notes which are missing. After notifying the regulator, Fifth Third's capital is subject to heightened scrutiny, and the bank



is prohibited to undertake any further acquisitions until its accounting controls are improved. The impaired assets are mainly inherited from Old Kent's accounts, and the Old Kent executive who took a divisional executive position is replaced. Fifth Third settles for \$17 million.

#### **FirstEnergy Corporation**

04/24/2002 to 08/05/2003

Whistleblower: Firm

Motivation: Smoothing earnings

The North American Energy Reliability Council, the utility self-regulation organization, informs federal energy regulators that the source of the largest electricity failure in North American history is due to problems at a FirstEnergy site. FirstEnergy, which becomes subject to a series of safeguards imposed by U.S. and Canadian authorities, settles with shareholders for their lack of proper controls and maintenance for \$89 million.

#### **Fluor Corporation**

05/22/1996 to 02/18/1997

Whistleblower: Firm

Motivation: Smoothing earnings

Using the occasion of an unrelated insurance gain, Fluor discloses cost overruns at two power plant projects and higher overhead costs in the power plant division as a whole. Suits allege that the failure to disclose cost concerns result from Fluor's executive bonus target guidelines. Fluor buys back stock, institutes cost restructuring and settles for \$18 million.

#### **Foamex International**

05/07/1998 to 04/16/1999

Whistleblower: Bank

Motivation: Personal profit

A breach of bank covenants force Foamex to disclose that it was facing a loss, a restatement of the prior 3 quarter earnings and a tax-related charge. During the quarter, Foamex's largest shareholder tries to acquire Foamex to provide liquidity for its own debt burden while not revealing the tentative position of Foamex debt. Foamex settles the subsequent class-action suit for \$2.5 million.

#### **Ford Motor Company**

12/01/1999 to 01/12/2002

Whistleblower: Board

Motivation: Smoothing earnings

When the board removes the CEO, new management faces a \$1 billion write-off of raw materials. Ford had not disclosed that it has been buying metals needed for now-unnecessary components under contracts made with metal suppliers at higher prices than the current situation. Not only does Ford not hedge the purchases, but it does not disclose than the decline in

input prices would decrease earnings when it off-loads the surplus.

#### **Fore Systems, Inc.**

07/19/1996 to 04/01/1997

Whistleblower: Analyst

Motivation: Industry Downturn

Following an analyst forecast that Japanese market for Fore's products is in decline, the firm acknowledges that its quarterly earnings will underperform due to flat revenue growth in the Japanese market. During the class period, executives of the firm had conveyed that the market was performing strongly and insiders sell \$26 million in stock. The SEC charges a former VP with insider trading. Fore settles for \$11.7 million

#### **Gateway, Inc.**

04/14/2000 to 02/23/2001

Whistleblower: Analyst

Motivation: Industry Downturn

After conducting research on Gateway by surveying computer stores and reviewing the firm's balance sheets, an equity analyst cuts his rating with the forecast of weak demand. Gateway denies the claims but then warns that holiday earnings will be \$500 million lower than Wall Street estimates, partly due to a \$200 million charge to write-down its investments. An SEC investigation, in which former officers are sued by the SEC for falsifying the accounting, forces the firm to restate its 1999, 2000, and 2001 results. Among other offenses, Gateway is investigated for booking barter revenue with AOL. Gateway settles the class-action suit for \$10.25 million.

#### **Global Crossing, Ltd.**

01/02/2001 to 10/04/2001

Whistleblower: Analyst

Motivation: Industry Downturn

As Global Crossing continues to make earnings targets but warns that future earnings may be impacted by the economy downturn, analysts following the firm discover irregularities in the firm's financials. Global Crossing is buying assets from its clients to fund their continued business. Additionally, \$1.7 billion of the firm's \$2.4 billion in cash is a result of drawing down on a bank line of credit. After Global Crossing has filed for bankruptcy, an internal letter from a finance executive outlines other accounting schemes, particularly bartered long-term contract revenue, that the firm uses to boost earnings. The firm settles for \$325 million.

#### **Global Crossing, Ltd.**

12/09/2003 to 04/29/2004

Whistleblower: Auditor

Motivation: Bank Financing/Public Debt Issuance

After getting sufficient financing such that it can emerge from Chapter 11, Global Crossings' auditor Grant Thornton resigns citing a lack of controls. A few weeks later, Global Crossing announces that its past financials understate liabilities by \$50-80 million due to internal control weaknesses.

#### **Goodyear Tire & Rubber Company**

10/22/1998 to 10/22/2003

Whistleblower: Internal unknown

Motivation: Bank Financing/Public Debt  
Issuance

During an internal review following a change in the accounting system at Goodyear, an internal auditor discovers \$100 million in billing errors back to 1998. An informal inquiry by the SEC and a second review by the firm reveal another \$65 million in overbooked earnings dating over six years. The SEC issues a Well Notice informing Goodyear that it is subject to a civil suit by the regulator.

#### **Grand Casinos**

12/19/1995 to 07/22/1996

Whistleblower: Firm

Motivation:

When Grand Casino's newly acquired subsidiary Stratosphere reports less-than-expected earnings, Stratosphere is forced to acknowledging that it has run out of cash and is taking a debt infusion from parent Grand Casinos. By doing so, Stratosphere confirms suspicions that Grand Casino's assessments of the completion and cash flow of the new casino were optimistic. Stratosphere eventually files for Chapter 11. Grand Casinos settles for \$9 million.

#### **GTECH Holdings Corp.**

07/13/1998 to 08/29/2000

Whistleblower: Employee

Motivation: Expansion

An employee of GTEch, a firm contracted by Camelot to provide terminals for the UK Lottery, informs Camelot and the Lottery that a computer glitch resulted in errors in tens of thousands of prizes over the years 1994-1998 and that the firm had known about it since corrections were made in 1998. The revelation causes GTEch and Camelot to lose the UK contract. Shareholder suits are settled for \$10 million.

#### **Halliburton Company**

07/22/1999 to 05/28/2002

Whistleblower: Newspaper

Motivation: Smoothing earnings

After Halliburton dismisses failing auditor Arthur Andersen, the New York Times publishing an article

outlining the firm's aggressive accounting, particularly those instituted under Vice President Dick Cheney's watch. A week later, Halliburton acknowledges that the SEC has begun an informal investigation into its practice of early revenue recognition. The SEC fines Halliburton \$7.5 million and brings civil suits against two executives. The firm settles shareholder suits for \$6 million.

#### **Hamilton Bancorp, Inc.**

04/21/1998 to 12/22/2000

Whistleblower: Industry regulator

Motivation: Personal profit

Bank regulators issue a cease-and-desist order imposing that Hamilton must increase reserves, alter accounting practices and maintain a higher capital ratio to account for its loan exposure in Latin America. As a result, the firm takes a charge and restates earnings for three years. Disputes regarding the regulator prescription and financial distress lead to the discovery of additional improprieties and to the dissolution of the firm. The class action suits combine and settle for \$8.5 million.

#### **Hamilton Bancorp, Inc.**

12/22/2000 to 01/11/2002

Whistleblower: SEC

Motivation: Personal profit

Soon after Hamilton engages in a dispute with the bank regulator over its loan loss reserves for Latin America exposures, the SEC begins an investigation into the firm's accounting practice. The SEC investigation reveals that Hamilton has engaged in practices of money laundering and hiding of liabilities in financing entities and triangle relationship arrangements in order to keep the stock price inflated for management to extract bonuses and stock options. Soon after Hamilton's auditor issues a 'going concern' report and the SEC investigation progresses, the firm liquidates. Hamilton settles for \$8.5 million.

#### **Hollinger International, Inc.**

08/13/1999 to 03/31/2003

Whistleblower: Equity holder

Motivation: Personal profit

Equity stakeholder Tweedy Brown Co. questions Hollinger's CEO Conrad Black about the use of his privately-help firms in transactions involving Hollinger. The related parties are funnels for executives at Hollinger to siphon payments and contracts at least valued at \$80 million which should have flowed to the firm. Hollinger executives are charged in civil suits by the SEC and face criminal investigation by the Chicago U.S. Attorney General's office. Hollinger settles with shareholder for \$50 million.

**Homestore.com, Inc.**

07/20/2000 to 12/21/2001

Whistleblower: Client

Motivation: Merger/Acquisition

Throughout 2000 and 2001, Homestore.com engages in round-trip advertising revenue booking with AOL. During the class period, Homestore.com acquires many of its competitors. When AOL pulls out of the deal, Homestore.com's Board conducts an inquiry, forcing the firm to announce that it will restate revenue. The internal investigation reveals problems with regards to non-advertising revenue as well. The DOJ and SEC file charges against several former executives. Homestore.com settles the class-action suit for \$63.6 million.

**Honeywell International, Inc.**

12/20/1999 to 06/19/2000

Whistleblower: Firm

Motivation: Merger/Acquisition

Honeywell lowers earnings expectations, citing the up tick in oil prices on input expense and acknowledging revenue shortfalls and shortages in parts. The CEO previously claims that the difficulties of integrating recently-acquired Allied Signal were passed, but revenue shortfalls still plague its division. Honeywell settles for \$100 million, \$85 million of which is covered by insurance.

**Household International, Inc.**

10/23/1997 to 08/14/2002

Whistleblower: Auditor

Motivation: Bank Financing/Public Debt Issuance

During its initial audit of Household International after winning the account from failing Arthur Andersen, KPMG discovers that Household has re-aged bad debt and failed to amortize branding agreements and to expense certain other marketing costs. Household restates earnings for the prior 3 years, taking nearly \$400 million off its balance sheet, triggering borrower covenants and forcing the firm to dilute its equity base to raise cash. During the class period, Household enters contracts for the bank to buy-back Household shares in the market in exchange for a commitment that the firm will purchase the shares from the bank within a year at a predetermined rate. The financial contracts amount to a bet by Household that its stock would rise. The SEC institutes an investigation.

**IAC/InterActiveCorp**

03/19/2003 to 08/04/2004

Whistleblower: Supplier

Motivation: Merger/Acquisition

When hotel chains start limiting the number of rooms allocated to Expedia and Hotels.com, IAC, the recent acquirer of these online travel providers not only

announces that their revenue is being hurt by limited access, but opens the door to a series of other accounting and revenue concerns. The New York Times had previously suggested that the stock run-up reflected management's abuse of accounting for its own benefit, but countering by Barry Diller, IAC's powerful CEO diffuses the pre-warning. With the hotel revenue shock, however, IAC reveals that they had been booking revenue on total transaction prices rather than simply their commissions as broker. In addition to not reporting the growing tension with hotel chains and airlines, the firm has problems of double-booking and overcharging, under-reporting tax expenses, copyright infringement, and service dissatisfaction.

**Idacorp, Inc.**

02/01/2002 to 06/04/2002

Whistleblower: Firm

Motivation: Smoothing earnings

In the period of post-Enron energy investigations, Idacorp, a utility involved in energy trading, warns that its earnings will fall below forecasts due to its energy trading division and the effect of a drought on hydro-production. Idacorp fails to reveal in a timely manner that it had adjusted its energy position to involve only short-term trades with less revenue potential because of regulator uncertainty, and that the lower volatility in the market would imply lower profits. Plagued by post-Enron investigations of transaction involving the West Coast energy markets and by regulation licensing violations, Idacorp ceases to participate in the energy trading business.

**IKON Office Solutions**

01/24/1996 to 08/11/1998

Whistleblower: Firm

Motivation: Merger/Acquisition

Ikon announces that its controls are inadequate, resulting in inaccurate reporting of defaulted leases and accounts receivable. The disclosure is accompanied by a costs charge associated with its aggressive acquisition policy. The announcement is accompanied by a plan to reorganize units to improve control. Ikon settles for \$111 million, \$37 of which is covered by insurance.

**Interpool, Inc.**

03/27/2001 to 12/29/2003

Whistleblower: Auditor

Motivation: Merger/Acquisition

In its initial audit after taking over from failing Arthur Andersen, KPMG finds that Interpool prematurely accounts for revenue in its finance leasing department. The firm acquired finance leasing accounts from Transamerica two years prior and had not exhibited proper internal controls over the transactions, eventually forcing the firm to re-state earnings back to

the merger. An SEC inquiry turns into a formal investigation and a de-listing from the NYSE.

#### **Interstate Bakeries Corp.**

04/02/2002 to 04/08/2003

Whistleblower: New management

Motivation: Personal profit

Interstate Bakery's new management announces that the firm would substantially miss its projected earnings, a fact that the company has silently known for several months. The former CEO and present CFO, among others, sell \$16 million of stock during the period in question. The announcement of the earnings shortfall is accompanied by the new CEO's stated goals to hire consultants and overhaul the firm. The firm settles for \$18 million the day before bankruptcy proceedings.

#### **Johnson & Johnson**

04/16/2002 to 07/18/2002

Whistleblower: Newspaper

Motivation: Smoothing earnings

The New York Times reveals that J&J had known for 3 months that incidences of a rare disease in its drug Eprex were increasing and that J&J was being criminally investigated under a qui tam suit regarding its Eprex manufacturing facility. In the meantime, the firm forecasts Eprex, and its US equivalent Procrit, sales to increase from 10% to 11% of revenues. French authorities regulate the use of Eprex.

#### **KeySpan Corporation**

04/26/2000 to 07/17/2001

Whistleblower: New management

Motivation: Merger/Acquisition

KeySpan's financial condition is overstated due to accounting irregularities in a newly acquired subsidiary. The lack of coordination between prior owners of the subsidiary and KeySpan management culminates in the firing of the subsidiary management triggering the announcement of the charge against KeySpan earnings. Insiders sell \$29 million of stock in the quarter prior to the disclosure. KeySpan settles for \$13.8 million.

#### **Kinder Morgan, Inc.: KN Energy, Inc.**

10/30/1997 to 06/21/1999

Whistleblower: Competitor

Motivation: Target Merger/Acquisition

When cash-troubled KN Energy's acquisition by a California utility falls through, KN Energy issues stock, diluting shareholder's interest, to arrange the merger with cash-rich Kinder Morgan. Former KN shareholders sue the firm for the distressed situation in which KN found itself prior to the merger. KN had pursued actively acquired many firms by inflating the firm's price by misrepresenting contract risk and

passing off extraordinary income as earnings. Kinder settles for \$5.2 million.

#### **Laboratory Corporation of America Holdings (LabCorp)**

02/13/2002 to 10/03/2002

Whistleblower: Firm

Motivation: Industry Downturn

Despite the company's recognizing a slowdown, LabCorp chooses not to disclose sales weaknesses as it was in a failed competition to acquire two companies to diversify its operations. LabCorp had failed to properly manage operations and was experiencing greater competition during the period of sales attrition. Executives sold \$26 million in stock during the 8-month class period.

#### **Lucent Technologies, Inc.: Common Stock and Debt Securities**

10/26/1999 to 12/21/2000

Whistleblower: New management

Motivation: Industry Downturn

Following earnings deterioration at Lucent which takes three-quarters of the value off the stock, Lucent brings in new management. The new CEO announces that an adjustment for a revenue recognition problem will lower sales by \$125 million. Information emerges that Lucent's slowness to adapt to technological changes encouraged the firm to undertake improper accounting via channel stuffing, failure to record returns, and the carrying of bad debt. After numerous revenue adjustments and asset write-offs, Lucent settles with shareholders for \$568 million.

#### **Marsh & McLennan Companies, Inc.**

11/01/1998 to 09/03/2003

Whistleblower: Employee

Motivation: Personal profit

After the SEC failed to take action on whistleblower Peter Scannell's accusations of fraudulent market timing and preferential trading by Putnam mutual funds, Scannell informs the State attorney general's office. Putnam, a division of Marsh & McLennan, allowed traders and favored customers to profit at the expense of its remaining clients, and the scandal that follows the information severely damages the fund's reputation and causes an exodus of capital. Civil and criminal charges are brought against Putnam and several traders. The class action suit is yet pending.

#### **MasTec, Inc.**

05/13/2003 to 04/12/2004

Whistleblower: Auditor

Motivation: Sell Out

As the controlling Mas family tries to sell of some of its holdings in an offering, the auditor forces MasTec

to delays quarterly reports due to control weaknesses. When the firm does file, it announces a \$52 million loss, with write downs of impaired assets and receivables, un-expensed costs, and overly aggressive revenue recognition. Losses for 2002 are restated. Two CFOs resign and a number of outside board numbers.

#### **Mattel, Inc.**

02/02/1999 to 10/01/1999

Whistleblower: Newspaper

Motivation: Merger/Acquisition

Mattel misrepresents the opportunities of its newly acquired firm, the Learning Company. BusinessWeek reports that Mattel's CEO conveys a negative outlook during an annual trade association meeting; the magazine infers that the firm's forthcoming Christmas revenues, in general, and, in particular, sales by the Learning Company might be at risk. A few days later, Mattel warns on third quarter earnings. Mattel has recently acquired the Learning Company to diversify strategically following a large earnings shock the prior year. Mattel settles for \$120 million.

#### **McDonald's Corporation**

12/14/2001 to 01/22/2003

Whistleblower: Board

Motivation: Expansion

Although analysts speculate that the introduction of new "Dollar Menus" and remodeling would not revive McDonald's after nearly three years of stagnation, it was the board's decision to replace management that brings to light the fact that many of McDonald's stores were underperforming and should be closed. New management took heavy charges to disgorge impaired assets, close stores and cancel new store growth to improve future margins.

#### **McKesson HBOC**

07/28/1998 to 04/28/1999

Whistleblower: Auditor

Motivation: Merger/Acquisition

Auditors Deloitte & Touche reveal that the much of revenue booked by HBOC, the software maker recently acquired by McKesson, are based on future projected sales without consideration for contingencies. After the firm begins to realize and admit the magnitude of the revenue recognition problem, investigations by regulators and federal criminal authorities discover that McKesson had been warned of revenue concerns by the auditor prior to the merger. Executives from former HBOC are indicted for criminal fraud. Executives from McKesson are fired, and McKesson settles class suits for \$960 million.

#### **Merck & Co., Inc.**

05/22/1999 to 10/22/2003

Whistleblower: Trade organization

Motivation: Smoothing earnings

In 2001 Cardiologists at the Cleveland Clinic report findings that patients taking Merck's globally-selling drug Vioxx have a higher risk of heart problems. The Clinic doctors conduct the study after one of the authors is alarmed by the Merck's discrediting of an internal 1999 study showing that although Vioxx takers have fewer ulcers than competing painkiller naproxin, Vioxx takers had a higher risk of heart attacks. A Merck study contracted at Harvard University confirms in 2003 the greater heart risk, at which point Merck acknowledges the issues and pulls Vioxx from retail shelves. Numerous consumer and class action cases are yet pending.

#### **Micro Warehouse Inc.**

03/26/1995 to 09/27/1996

Whistleblower: Internal unknown

Motivation: Merger/Acquisition

While upgrading the automation of its accounting system, accounting staff at Micro Warehouse uncover manual accounting entries which inflate earnings by improperly adjusting receivables for defective inventory, stock rotation, and price protection, thus requiring restatements of its 1994 and 1995 fiscal year earnings. Following a subsequent internal investigation with hired outside auditor KPMG, the firm fires the CFO and CAO for conducting a scheme to inflate earnings. The firm, CFO, and CAO settle with the SEC. The firm settles the shareholder suits for \$30 million.

#### **Mobilemedia**

07/29/1995 to 09/27/1996

Whistleblower: Equity holder

Motivation: Merger/Acquisition

Equity investor H&F uses its seats on MobileMedia's board to fire the CEO after a failure to integrate newly acquire MobileComm resulted in skyrocketing expenses and customer attrition. Prior management continues to be optimistic about the merger until they are removed. Subsequent to the management change, MobileMedia also discloses that it is in violation of licenses with the FCC. A number of MobileMedia's licenses with the FCC are revoke. Mobilemedia files for Chapter 11 and settles for \$26.5 million.

#### **Motorola, Inc.**

02/03/2000 to 05/14/2001

Whistleblower: Analyst

Motivation: Expansion

Following a careful study of Motorola's SEC filing, a bond analyst to reveal that the firm has a \$2 billion exposure in vendor financing with Telsim, a mobile phone operator in Turkey. Up to that point, Motorola had not revealed the extent to its dependence on

vendor financing arrangements for its revenue. Additionally, Motorola does not indicate that it is having a problem with the vendor debt until \$728 of the loan was past due, at which point Nokia and Motorola file a suit against Telsim. Motorola writes off much of the debt and then wins in U.S. courts under racketeering charges against the family running Telsim. Class action suits are yet pending.

#### **National Golf Properties, Inc.**

05/11/1999 to 04/01/2002

Whistleblower: Firm

Motivation: Personal profit

Real estate firm National Golf discloses that its primary lessee, American Golf, is unable to pay rent on its properties. American Golf is closely held by National Golf's chairman and CEO, an association shareholders claim is used to defraud outside holders via financial self-dealings. Distress at American Golf arising out of debt covenant breaches forces National Golf to address the relationship. American Golf enters bankruptcy, and National is bought out by investors after replacing management. National settles for \$4.2 million.

#### **National Golf Properties, Inc.**

05/11/1999 to 04/01/2002

Whistleblower: Law firm

Motivation: Personal profit

In the process of discovery concerning the class action suit against National Golf, the law firm discovers that National Golf has issued \$31 million worth of equity paid to the benefit of Oaks Christian High School thereby diluting shareholders value. The cases are later combined into a single suit. National is bought out by investors after replacing management. National settles for \$4.2 million.

#### **NDCHealth Corporation**

10/01/2003 to 03/31/2004

Whistleblower: Firm

Motivation: Bank Financing/Public Debt Issuance

NDC announces that it is delaying release of its quarterly earnings under concerns for its revenue recognition process. The internal investigation is joined by a SEC inquiry, later leading to an SEC investigation. The timing of recognizing software revenue in advance of GAAP treatment forces the firm to restate earnings for three years prior. The firm puts itself on the sales block and has recently gone into technical default.

#### **Network Computing Devices, Inc.**

02/02/1995 to 03/21/1996

Whistleblower: Client

Motivation: None

Several large product orders returns sparks NCD to undertake a detailed review of the original sales documents, raising doubts about aggressive revenue recognition associated with these orders. During the class period, insiders made \$14.6 million from the sale of NCD's stock. As a result of the initial review, the firm conducts an internal review, restates earnings and induces the resignation of the CEO and CFO. NCD settles for \$12 million.

#### **New York Community Bancorp, Inc.**

06/27/2003 to 05/09/2004

Whistleblower: Analyst

Motivation: Target Merger/Acquisition

Analyst report that NY Community Bancorp's increase of short-term obligations, which are in turn leveraged into bank growth, are used by the bank to improve its desirability for its planned sale of the company at the expense of higher interest rate risk in an environment of low interest rates and few opportunities. As a result of the leveraging, the bank manipulates the desirability of the firm, thus inflating the stock price.

#### **Nicor, Inc.**

01/24/2002 to 07/21/2002

Whistleblower: Employee

Motivation: Value Enhancement

An insider whistleblower faxes the local energy consumer board a letter detailing how Nicor, a utilities provider, cheated customers by inflating expenses which are used to justify rates and by over-counting the service hours to be billed. The SEC's formal investigation results in a civil penalty of \$1.1 million to be refunded to consumers; three executives are indicted. Nicor settles the class action suit for \$38.5 million.

#### **Nike, Inc.**

06/29/2000 to 02/26/2001

Whistleblower: Firm

Motivation: Smoothing earnings

Nike warns that profits will be lower than expectations due to supply chain management failures in matching client orders with factory production. The firm fails to issue timely warnings to investors of pending earnings impact to software failures. Nike settles for \$8.9 million.

#### **Northeast Utilities**

04/05/1994 to 04/04/1996

Whistleblower: Employee

Motivation: Value Enhancement

Whistleblower George Galatis informs multiple federal regulators of problems in refueling at Northeast Utilities' Millstone nuclear reactor. The Nuclear Regulatory Commission, after a length investigation, finds Galatis's claims to be

substantiated, closes plants, and initiates criminal investigations of the firm and a number of officials. The shareholder settlement includes \$5 million not covered by insurance.

#### **Northstar Health Services**

05/17/1994 to 03/26/1996

Whistleblower: Auditor

Motivation: Personal profit

Following the merger of Northstar with KeyStone, independent auditor KPMG takes over the ever-growing Northstar account and then resigns, citing serious concerns regarding Northstar's accounting practices and certain related party transactions involving the former chairman and CEO. The business practices involve over-paying on leases and payouts on a series of smaller mergers. The Board hires Arthur Andersen and several law firms to conduct an investigation into KPMG's concerns, firing two directors in the process, and eventually Northstar files a RICO suit against the former CEO, former auditor Richard Eisner & Co, and several other parties. After settling with the former CEO, Northstar settles the class-action suit for \$6.45 million.

#### **NUI Corporation**

11/08/2001 to 10/17/2002

Whistleblower: Auditor

Motivation: Value Enhancement

When auditor Deloitte & Touche reports a lack of controls on ventures and acquisitions, non-reconciled capital accounts and projects without costs allocated, State regulators conduct a comprehensive audit of NUI, an energy provider. The audit reveals that NUI was taking funds from regulated sectors to subsidize failing other entities including energy trading. As a result, the rate charged to public utility consumers was inflated, a criminal act. NUI settles with State regulators, agreeing to refund consumers \$30 million, and pleads guilty to the SEC for criminal conduct with a fine of \$500,000. NUI forces out the managing family and sells the firm.

#### **Olsten Corporation**

05/31/1996 to 11/21/1996

Whistleblower: Employee

Motivation: SEO

California regulators had been investigating Quantum Health for Medicare over-billing when Olsten acquired the firm. New Mexico investigators announced that their similar investigations discovered a payout plan of gifts to encourage patients to take more product than necessary, thus over-booking the government for Medicare-covered items. Olsten eventually settles with New Mexico, reimbursing the government \$4.5 million. Class action suits are combined with other impropriety suits and settle for \$24 million.

#### **Olsten Corporation**

05/31/1996 to 11/21/1996

Whistleblower: Industry regulator

Motivation: SEO

Donald McClendon, an executive employee of Olsten whose firm had recently been bought by Olsten, serves as the internal source of information for a federal investigation of Medicare fraud against Olsten. Olsten was already being investigated in its newly acquired Quantam unit when federal authorities begin to look at the firm as a whole and approach McClendon. The U.S. Attorney General confirmed that funds were being allocated to federal investigators to root out Medicare fraud happening across the country. Olsten pays a wrongful termination settlement to McClendon, a fine of \$61 million to the government and settles class action cases for \$24 million.

#### **Olsten Corporation**

05/31/1996 to 11/21/1996

Whistleblower: Firm

Motivation: Merger/Acquisition

After recently acquiring Quantam Health to employ the target's model of home health care, Olsten fails to disclose that the firm is unable to turn a profit in the home health care sector due to competition from managed-care entities, staffing shortages and integrating not within its core competency. During the class period, Olsten executives sell \$10 million in firm stock. The case is later combined into other class action suits and settles for \$24 million.

#### **Omnicom Group, Inc.**

02/20/2001 to 06/11/2002

Whistleblower: Director

Motivation: Industry Downturn

An Omnicom director resigns with the statement that he disagrees with the firm's use of an asset-sheltering entity. Follow-up newspaper reporting reveals that the entity is being used by the firm to avoid having to write-down the value of internet assets which the firm had acquired during the internet bubble. The Enron fallout over accounting via special purpose entities and the questionable role of Arthur Andersen make the audit committee, and especially the whistleblowing director, especially sensitive to sheltering concerns.

#### **Orbital Sciences**

04/21/1998 to 02/16/1999

Whistleblower: Auditor

Motivation: SpinOff

Orbital Sciences' auditor KPMG advises the firm to change certain accounting methods, including how it recognizes revenue and expenses. Although Orbital announces a quarterly earnings related its new

accounting practices, and the residual of the year, a continuing disagreement with its auditor KPMG over the need for further restatements and accounting practices changes resulting in KPMG being fired. During the class period, Orbital twice tries to spin off its OrbComm subsidiary, an entity responsible for some of the revenue concerns. Client NASA reviews its contracts with Orbital, and advises its field offices to proceed with caution when dealing with the firm. Orbital Sciences settles for \$22.5 million.

#### **Pediatric Services of America, Inc.**

12/23/1997 to 07/28/1998

Whistleblower: Rating agency

Motivation: Bank Financing/Public Debt  
Issuance

In rating a Pediatric Services' debt issuance, S&P states concern that the small-based firm which has made a large number of acquisitions would not be able to exert proper control of the entity. After experiencing very rapid revenue growth during the class period, Pediatric Services takes a charge to increase reserves for uncollectible receivables arising out of the old accounting system. The firm settles the subsequent class-action suit for \$3.2 million.

#### **PeopleSoft**

05/27/1998 to 01/28/1999

Whistleblower: Analyst

Motivation: Merger/Acquisition

When PeopleSoft performs above forecast but below expectations, analysts taking a closer look at financials conclude from accounts receivable that growth is slowing. After denying a slowdown in sales for another 3 quarters, PeopleSoft finally admits slowing growth, reports earnings below estimates and warns on the following quarter. PeopleSoft also reveals that the SEC is investigating its accounting methods in recent acquisitions. The SEC later deems the firm's accounting practices appropriate. PeopleSoft settles for \$15 million.

#### **Peregrine Systems, Inc.**

07/19/2000 to 05/06/2002

Whistleblower: Auditor

Motivation: Industry Downturn

KPMG's initial audit of Peregrine Systems after taking over for failing Arthur Andersen results in a delay of earnings reports and an internal investigation into irregularities. The firm announces that it will restate the two prior years and fires KPMG for conflict of interest over the restatements. Peregrine restates revenue down by \$100 due to improper recognition in sales channels, takes a \$100 charge to expense stock options and writes off \$100 in accounts receivable. The firm is investigated for fraud by the SEC and DOJ and files for Chapter 11. The CFO and VP of sales plead guilty to conspiracy.

#### **PerkinElmer, Inc.**

07/15/2001 to 04/11/2002

Whistleblower: Firm

Motivation: Merger/Acquisition

The need to restructure by laying off employees and writing-off obsolete inventory forces PerkinElmer to reduce its earnings forecast and take a restructuring charge. The firm had previously been overly optimistic in statements that it would meet performance targets. The inventory obsolescence, decline in product demand, and costs associated with numerous recent acquisitions had not been divulged. Case is yet pending.

#### **Pharmacia Corporation**

04/17/2000 to 08/21/2001

Whistleblower: Industry regulator

Motivation: Smoothing earnings

The FDA, presumably disillusioned by Pharmacia's contracting an analysis of its blockbuster arthritis drug Celebrex only using half of the data, publishes the entire data set on its website. The study was undertaken by Pharmacia to show that Celebrex causes less ulcers than other treatments, a claim that the full sample of data cannot prove statistically. In addition, Cleveland clinic cardiologist who are whistleblowers in a similar Merck case concerning its drug Vioxx, study the Pharmacia data and reveal that the incidence of heart attacks is higher for patients taking the COX-2 type drugs of Celebrex and Vioxx. The FDA and European regulators do not allow Pharmacia to make its claims on diminished chances of ulcers; the Department of Justice investigates Pharmacia's actions and class action cases are yet pending.

#### **PMA Capital Corporation**

05/05/1999 to 02/11/2004

Whistleblower: Analyst

Motivation: Bank Financing/Public Debt  
Issuance

In rating PMA Capital's new debt issue, Moody's highlights that concerns are strong that the loss reserve charge recently taken by PMA might be inadequate to the re-insurance exposure the industry is facing for policies written in prior periods. After CS First Boston reiterates the same concern 4 months later, PMA take a charge to its loss reserves and announces that it is in negotiations with the State regulator. PMA pulls out of the reinsurance business and changes management.

#### **PNC Financial Services**

07/19/2001 to 01/29/2002

Whistleblower: Industry regulator

Motivation: Industry Downturn

In an environment of heightened post-Enron scrutiny



of financial subsidiaries, the Federal Reserve forces PNC to take an earnings adjustment to write-off non-performing loans that PNC has transferred to a financial entity. The bank settles with the Fed and becomes subject to a strict monitoring scheme imposed by the regulator before settling the class action suit for \$193 million.

#### **Polaroid Corporation**

04/02/2001 to 08/16/2001

Whistleblower: Federal investigative agencies  
Motivation: Bank Financing/Public Debt Issuance

After Polaroid files for Chapter 11, the court appoints an investigator to inquire into the claims by shareholders that the bankruptcy was unnecessary. The investigator discovers that Polaroid had been trying to hide from financiers the non-viability of the firm, rather than deceiving shareholders as to its worth. Polaroid's cover-ups concern the use of non-feasible tax credits and reserves, and the portraying of short-term debt as longer-term obligations.

#### **Qwest Communications International, Inc.**

05/24/1999 to 02/14/2002

Whistleblower: Newspaper  
Motivation: Sell Out

Morgan Stanley analysts assert that Qwest's exposure to failing Dutch venture KPNQwest, Qwest improper pension accounting and its capitalization of software costs will hurt future earnings for the firm. After vehemently denying the report, Qwest writes off \$3.1 billion the following month. Despite Qwest claims to the contrary, the market value of the Dutch venture had been known to be significantly less than its value on Qwest's balance sheet. Later in the year, Morgan Stanley's suggestions that accounting at Qwest is overly aggressive also proves to be true, as Qwest later warns on revenues. Qwest's CEO sold over 4 million shares during the period.

#### **Qwest Communications International, Inc.**

10/24/2000 to 10/30/2001

Whistleblower: Analyst  
Motivation: Industry Downturn

Following the prior woes of Qwest's venture in the Netherlands and accusation of accounting concerns by Morgan Stanley, the Wall Street Journal discovers that Qwest has been generating revenue by using a three-party scheme to buy and re-sell equipment, improperly booking the entire transaction as revenue. In the subsequent 8 months, Qwest embarks on a series of internal investigations and a change in auditor and management and eventually writes off \$20-30 billion in assets and re-states \$2.5 billion in earnings due to improper accounting entries.

#### **Raytheon Company**

10/17/1998 to 10/12/1999

Whistleblower: Newspaper  
Motivation: Smoothing earnings

The Wall Street Journal reports that defense contractor Raytheon is behind schedule and over costs on a number of government contracts. The firm had previously take a \$350-450 charge for restructuring, but fails to reveal problems with production, including the loss of a Navy contract, which require additional charges of \$320 million and loss of future revenues. The company settles with shareholders for \$410 million.

#### **Revlon**

10/29/1997 to 10/01/1998

Whistleblower: Firm  
Motivation: Target Merger/Acquisition

Facing the need to restructure labor and debt, Revlon warns that quarterly earnings will fall well shy of Wall Street estimates due to reduced inventory levels and decreased demand from consolidating drug stores. Investors charge Revlon with channel stuffing their distribution lines, presumably time both with Revlon's acquisition of the Cosmetic Center and with Revlon's putting its highly leveraged entity on the block. After stopping shipments for the rest of the year to relieve the inventory glut, Revlon settles with investors for \$9.9 million.

#### **Rite Aid Corp**

05/02/1997 to 11/10/1999

Whistleblower: Officer  
Motivation: Bank Financing/Public Debt Issuance

Joseph Speaker, a senior finance executive at Rite Aid, informs the board of large accounting irregularities at Rite Aid. After firing the CFO, naming Speaker as CFO, and conducting an internal audit, the board admits to overstating earnings by \$1.1 billion, primarily in inventory overvaluation. In the process, the investigation discovers that the soon-to-be-fired CEO hid pledges on assets backing short-term debt. Rite Aid suits are combined with prior class action and settles for \$200 million.

#### **Rite Aid Corporation**

12/14/1998 to 03/11/1999

Whistleblower: Firm  
Motivation: Expansion

Rite Aid fails to disclose delays in opening its new distribution center and costs, especially from inventory liquidation, related to its large scale relocation and opening of stores. Just over two weeks prior to its release of quarterly earnings, Rite Aid cuts earnings projections by half. The resulting class action case is later engulfed into a single suit with

additional impropriety claims. The combined suit settles for \$200 million.

#### **Schein Pharmaceutical, Inc.**

04/09/1998 to 09/28/1998

Whistleblower: Industry regulator

Motivation: IPO

Between 1994 and 1998, the FDA inspects the Steris Laboratories subsidiary many times and found manufacturing problems that remain "substantially uncorrected." In its IPO registration statement and prospectus, Schein reveals that it failed its most recent FDA inspection, but suits later claim that the firm does not disclose the full extent of the problem. The FDA soon seizes all products manufactured by its Steris Laboratories subsidiary and shuts down production, which accounts for 40% of its revenue and 50% of its gross profits. After complying with an FDA consent decree, Schein settles for \$8 million.

#### **Schering-Plough Corporation**

05/09/2000 to 02/15/2001

Whistleblower: Industry regulator

Motivation: Value Enhancement

The FDA's continuing investigations of Schering-Plough's manufacturing in New Jersey and Puerto Rico find severe manufacturing noncompliance issues. The FDA has been advising the firm of concerns for over a year. Meanwhile, Schering-Plough's petition to the FDA for approval of Clarinex, a successor drug to its blockbuster Claritin, whose patent is expiring, is held up by the FDA while manufacturing concerns are resolved. The case becomes publicly charged as the FDA turns over the case to criminal authorities. Skirting prosecution, Schering-Plough settles accepts a fine of \$500 million from the FDA in a consent decree.

#### **Scholastic Corporation**

12/06/1996 to 02/20/1997

Whistleblower: Firm

Motivation: Bank Financing/Public Debt Issuance

Scholastic fails to disclose in a timely manner that sales are waning in its primary revenue product, the Goosebumps series of children's books, and that it lacks controls to monitor sales adequately. Scholastic warns of a significant loss and announces it will take a charge primarily to increase reserves for anticipated returns of retail stock. The SEC later files a suit alleging insider trading against several individuals, including a Scholastic executive. Scholastic settles the shareholder suit for \$7.5 million.

#### **Scientific-Atlanta, Incorporated**

04/19/2001 to 07/19/2001

Whistleblower: Analyst

Motivation: Industry Downturn

An analyst meeting at an industry conference results in pessimism about Scientific-Atlanta's outlook and an equity ratings downgrade. A few days later the firm warns on the fiscal year income. Previous statements by the firm had reaffirmed that although the industry as a whole was slumping, the nature of Scientific-Atlanta's cable products would withstand a negative impact. Additionally, the firm would have known that distribution channels were already over-supplied. During the class period, executives sold \$38 million in shares.

#### **Sears, Roebuck & Co.**

01/17/2002 to 10/17/2002

Whistleblower: Officer

Motivation: Industry Downturn

In firing the head of the credit card division for Sears due to "personal credibility" issues, Sears CEO opens this area of the firm to intense scrutiny. Information emerges that Sears is carrying a large portfolio of uncollectible accounts for which its control system has failed to sufficiently take provisions, despite Sears claims in the annual report that the reserves are adequate. The case is yet pending.

#### **Service Corporation International**

04/29/1999 to 04/19/2002

Whistleblower: Employee

Motivation: Value Enhancement

When managers of Service Corp.'s Menorah Gardens funeral home realize that the engineering of its plots is faulty, workers begin to remove caskets and corpses as deemed necessary such that new caskets can be laid next to family members. Some corpses are later found in the woods. The information comes to light when a fired employee files a suit against the firm and tells the judge that he was made to desecrate graves. Service pays \$10 million to the State government under a civil settlement and \$100 million to families of the deceased. One employee is indicted. The firm agrees to bury the poor for free.

#### **Service Corporation International**

07/17/1998 to 01/26/1999

Whistleblower: Firm

Motivation: Merger/Acquisition

Ten days after antitrust approval is given to Service Corp., a funeral home provider, to purchase rival Equity Corp., Service announces that lower mortality rates have lowered earnings for the year. The CEO resigns, and the firm settles with former Equity shareholders for \$65 million.

#### **Shopko Stores, Inc.**

03/09/2000 to 11/09/2000

Whistleblower: Firm  
Motivation: Merger/Acquisition

Shopko discloses that it has been unable to coordinate merchandise on its retail floors with that contained in its advertising, an issue stemming from problems a clogged distribution center. ShopKo failed to disclose, until this point, integration and expansion problems with newly acquired Pamida resulting in the distribution failures. ShopKo settles the class-action suit for \$4.9 million.

#### **Silicon Graphics, Inc.**

07/24/1997 to 10/06/1997

Whistleblower: Newspaper  
Motivation: Bank Financing/Public Debt Issuance

After Business Week portrays Silicon Graphics as a firm in decline, the firm misses its positive earnings expectations, reporting a quarterly loss instead. The firm reveals that it had been pulling revenues from future quarters to make past quarterly targets, and future revenues would also be impacted. During the class period, the firm exchanges outstanding debentures for convertible debt and insiders sell \$7.4 million in stock. The firm settles for \$4 million.

#### **Soletron Corporation**

06/18/2001 to 09/26/2002

Whistleblower: Employee  
Motivation: Industry Downturn

Ronald Sorisho, a divisional CFO, files a whistleblower suit alleging that Soletron fired him for trying to force the company to write down substantial quantities of obsolete inventory. The company had known about the inventory for nearly a year and a half when it announces an inventory charge a week after Sorisho files the suit. The case is yet pending.

#### **Sotheby's Holdings, Inc.**

02/11/1997 to 01/29/1998

Whistleblower: Federal investigative agencies  
Motivation:

The Department of Justice indicts Sotheby's for price fixing after a long investigation of the art industry. Shareholders sue the firm for failing to disclose that a large portion of their revenues are being derived from the unsustainable higher prices from the pricing arrangement with Christie's. A number of individuals are indicted. Sotheby's settles customer class action suits for \$512 million and securities suits for \$70 million.

#### **Sprint Corporation: FON and PCS Common Stock**

10/04/1999 to 09/19/2000

Whistleblower: Law firm  
Motivation: Personal profit

A law firm releases its class action suit to the New York Times the day before filing in court, alleging that the Sprint executives profited greatly from the failure of the merger with MCI Worldcom. During the merger negotiations, Sprint executives alter the charter such that their option payout is vested not by the takeover, but by the vote of shareholders to accept the offer. The value of the packages is in the "hundred of millions of dollars". The managers would have known that there was a high probability that the federal antitrust authorities would block the merger, which is indeed what happens. Many of the executives with option packages left the firm prior to the suit. Sprint settles for \$50 million.

#### **Sprint Corporation: FON and PCS Common Stock**

10/17/2000 to 02/05/2003

Whistleblower: Newspaper  
Motivation: Personal profit

An article by the New York Times alerts the IRS to the existence of four tax shelters promoted by Ernst and Young. Subsequent IRS investigations charge Sprint's top executives with person tax evasion via a mechanism to allow them to cash out options without incurring tax liability for up to 30 years. The scheme saves the individuals substantial tax liabilities, some of which are internalized by Sprint. The board forces out the executives and suits are yet pending.

#### **SPX Corporation**

07/28/2003 to 02/26/2004

Whistleblower: Analyst  
Motivation: Smoothing earnings

SPX's quarterly reports reveal a 25% earnings increase over the prior year, but analysts note that the earnings were largely due to a legal settlement payment from Microsoft. Pressured by analysts, the firm holds an analyst dinner and acknowledges that the firm has poorly communicated and that it is experiencing a downturn in operating margins. The CEO sold \$41 million of stock during the class period, up until the day prior to the announcement.

#### **SUPERVALU, Inc.**

07/12/1999 to 06/25/2002

Whistleblower: Employee  
Motivation: Smoothing earnings

During a routine internal audit, a Supervalu controller admits that she had been understating the cost of goods sold. After the employee resigns, the firm conducts a full audit and eventually restates earnings for three years. The firm settles for \$4 million.

#### **Symbol Technologies, Inc.**

10/19/2000 to 02/13/2002

Whistleblower: Internal unknown  
Motivation: Merger/Acquisition

After an anonymous employee's letter to the SEC details accounting irregularities of two transactions and suggests that many more improprieties exist, the SEC initiates an investigation of Symbol Technologies. Symbol's activities included channel stuffing, booking of revenue to false customers or for inventory that would be returned or never actually left the premises, making acquisitions to hide declining earnings in merger accounting and falsifying invoices for the SEC staff. All top management resign; some are indicted. Symbol settles with shareholders for \$98 million.

#### **TECO Energy, Inc.**

10/30/2001 to 02/04/2003

Whistleblower: Analyst

Motivation: Bank Financing/Public Debt  
Issuance

After multiple rating agencies downgrade power company TECO, the local Tampa Tribune reports that TECO's exposure to Enron's bankruptcy is as much as \$300 million plus guarantees made by TECO for Enron power plant projects. TECO had previously denied that its exposure to Enron would be large. TECO is eventually downgraded to junk, takes charges of \$762 million and \$480 million to earnings and writes off power plant projects impaired for \$1.2 billion.

#### **Telxon Corporation**

10/22/1998 to 12/10/1998

Whistleblower: Auditor

Motivation: Target Merger/Acquisition

Telxon's desire to be acquired for \$900 million by Symbol Technologies fell through when Symbol's auditors discovered revenue recognized when the items were passed into the distribution line, even though Telxon was contractually obligated to take product back that did not sell. After restatements, charges and management changes, Symbol eventually acquires Telxon for half of the original offer price. Telxon settles with shareholders for \$37 million.

#### **Tenet Healthcare Corporation**

01/11/2000 to 11/07/2002

Whistleblower: Employee

Motivation: Value Enhancement

Although analyst UBS Warburg publicizes his worries about Tenet's Medicare 'outlier' payments for treatment above Medicare coverage limits, an inside employee brings the fraud to light when he informs federal authorities of unnecessary heart surgeries conducted at a Tenet hospital. The unnecessary procedures result in, among other things, Tenet's overbilling of Medicare and patients. Subsequent investigations by the firm, federal health agencies and the SEC ensue. A number of health and securities suits are still pending.

#### **Textron, Inc.**

10/19/2000 to 09/26/2001

Whistleblower: Client

Motivation: Smoothing earnings

Three accidents of Textron's Osprey helicopters kill 26 marines in 2000, triggering the government to ground the helicopter. Nearly a year later, Textron announces that redesigning the structural problems with the aircraft would take two years to redesign. The firm had known that the problems with the aircraft were fundamental to the hydraulic system from evidence from the crashes the year prior.

#### **The Boeing Company**

07/21/1997 to 10/22/1997

Whistleblower: Firm

Motivation: Expansion

Boeing fails to reveal that as a result of a large number of orders, understaffing, and supplier delinquencies, the production lines would have to be halted to deal with backlog and sequencing. Boeing had previously announced that the production problems were temporary and were being resolved. Instead, Boeing is forced to take \$2.6 billion in charges. Boeing settles the class action suit for \$92.5 million.

#### **The Interpublic Group of Companies, Inc.**

10/28/1997 to 10/16/2002

Whistleblower: Board

Motivation: Merger/Acquisition

A change in procedures making accounting more integrated among its many divisions results in Interpublic's discovery of revenue taken across divisions not being expensed properly. These divisions are results of an aggressive acquisition period for the firm. The board's heightened concern over the validity of financial statements in the post-Enron environment forces the firm to identify numerous small transactions that were improperly recorded. The firm restates earnings for 5 years, and the Board makes numerous management changes. Interpublic settles for \$77 million.

#### **The St. Paul Companies, Inc.**

11/05/2001 to 07/09/2002

Whistleblower: Firm

Motivation: SpinOff

Although St. Paul is sued by Western MacArthur for an asbestos liability in March, St. Paul does not make public the magnitude of the suit exposure until the firms settle in May for \$1 billion. St. Paul is under-reserved by \$380 million, which significantly impacts firm value and worries analysts about other exposures. During the class period, St. Paul was trying to spin off its reinsurance arm, but the negative impact of the asbestos exposure and the poor IPO market deter the offering. St. Paul settles for \$6.3 million.

**The St. Paul Travelers Companies, Inc**

04/01/2004 to 08/05/2004

Whistleblower: Firm

Motivation: Merger/Acquisition

Following the merger of St. Paul and Travelers, the combined entity announces that due to the aggressive use of actuarial calculation of reserves and reserve needs on the part of St. Paul, St. Paul Travelers would have to take a charge of \$1.6 billion to bring the reserves into adequacy. At the time of the merger, the firm fails to disclose the very different accounting approaches. The information comes to light as St. Pauls asks the SEC if they can attribute the adjustment to merger valuation rather than taking an expense event.

**Thomas & Betts Corp.**

04/28/1999 to 12/14/1999

Whistleblower: Firm

Motivation: Merger/Acquisition

Conversion of its control system following a series of acquisitions leads Thomas & Betts to uncover accounting irregularities in billing. The irregularities and troubles in implementing its previously praised web-based order processing are revealed by the firm as it misses earnings targets by 40%. Three executives are charged by the SEC for securities laws violations concerning the accounting records. Thomas & Betts settles for \$46.5 million.

**Triton Energy Incorporated**

03/30/1998 to 07/17/1998

Whistleblower: Firm

Motivation: Target Merger/Acquisition

Triton's CEO attempts to sell the company by inducing much fanfare in the bidding interest and making an assessment that the value should be \$50/share. (The CEO's options become in the money at a price of \$40.) Triton later reveals it has not received an acceptable offer, announces a \$160 million after-tax charge reflecting current low oil prices, writes-off exploration expenditures in war-torn Columbia, restructures the firm's activities, and fires the CEO. Triton settles for \$42 million.

**Twinlab Corporation**

04/27/1999 to 11/15/2000

Whistleblower: Firm

Motivation: Industry Downturn

Twinlab warns on its earnings due to an internal investigation of missing inventory in its Utah plant and a cutback from a major client. The firm restates the prior two years' earnings, ceases to market certain products and restructures. Managers return bonuses for the period. Soon thereafter, Twinlab files for Chapter 11 and then settles the class-action lawsuit for \$3 million.

**TXU Corporation**

04/25/2002 to 10/11/2002

Whistleblower: Analyst

Motivation: SEO

Despite the utility provider's claims to the contrary, a Merrill Lynch analyst asserts that TXU's continued regulation problems in the UK market would lower earnings for the entire firm. TXU re-asserts the strength of its European position and promises \$500 million to support the subsidiary. The firm backtracks on the promise, allows the UK unit to default and writes off \$4.5 billion. During the class period, TXU raises nearly \$1 billion on the equity markets. Shareholder suits are settled for \$150 million.

**Tyco International Ltd.**

02/01/2000 to 02/01/2002

Whistleblower: Newspaper

Motivation: Personal profit

The SEC Insight, a newspaper whose information is taken from SEC documents obtained by the Freedom of Information Act, discloses that Tyco may be subject to an SEC investigation, reinforcing short seller David Tice's prediction that Tyco's growth is a result of aggressive accounting. Soon thereafter, Tyco warns on earnings and halts its massive flow of acquisitions. In the coming months, information emerges that Tyco had paid an outside director and his charity \$20 million for arranging an acquisition that later fails and that Tyco spent \$8 billion in acquisitions not previously disclosed to its shareholders. Tyco takes a charge of approximately \$1 billion on revenue recognition reversals. CEO Kozlowski and CFO Swartz are found guilty of stealing more than \$150 million from the company, including loans made to finance art and apartments.

**UICI**

01/17/2000 to 07/21/2003

Whistleblower: Board

Motivation: Bank Financing/Public Debt Issuance

When UICI's board fires CEO, new management announces that the firm will take a charge for having insufficient collateral for the Academic Management Service loan program. Not only was income overstated, but the lack of proper controls made the firm out of compliance with regulators. All of the loans in question must be re-negotiated with financial institutions. The SEC begins an inquiry, and the division is soon sold to Sallie Mae.

**Union Pacific Corporation**

03/04/1997 to 10/01/1997

Whistleblower: Employee

Motivation: Merger/Acquisition

After a series of train collisions kill 12 people in 8

months and during increased regulator scrutiny, a Union Pacific union threatens to strike and informs the regulator that safety procedures are inadequate. The firm failed to divulge that the recent integration with Southern Pacific resulted in difficulties with traffic, delays, understaffing and safety problems resulting from poor training and over-working of employees. The firm creates adds a safety executives, reorganizes its routes and settles for \$34 million.

#### **Unisys Corporation**

05/04/1999 to 10/14/1999

Whistleblower: Firm

Motivation: Merger/Acquisition

Unisys fails to disclose possible contingencies in the recent contract signings with the U.S. government and British Telecom. Unisys's touting of \$26 billion of contract revenue over the next 10 years increases the firm's stock price, and facilitates an acquisition. Unisys reveals the contract failures during an earnings announcement in which doubts are cast on future revenues. The firm settles with shareholders for \$5.8 million.

#### **UNUMProvident Corporation**

02/04/1998 to 08/03/1999

Whistleblower: Firm

Motivation: Merger/Acquisition

Shortly after the completion of the merger between UNUM and Provident, the firm announces an earnings shock due to unexpected merger cost and additional claims incidence. The firm fails to disclose at the time of the merger or during the due diligence process that insurance claims rejections were unsustainably high, resulting in law suits and unpaid claims which would accrue to the combined company. Reserves for such claims were also inadequate. UNUMProvident settles for \$45 million.

#### **UnumProvident Corporation**

05/07/2001 to 02/04/2003

Whistleblower: SEC

Motivation: Bank Financing/Public Debt Issuance

The SEC begins an inquiry into UNUMProvident's accounting for investments during routine procedures and following a sale by the firm of some investment assets for which UNUM must take a write-down. The firm announces a charge and later restates earnings downward for 2000-2002 following the SEC prescription. During the class period, UNUM raises \$250 million in a bond offering.

#### **USN Communications**

02/04/1998 to 11/20/1998

Whistleblower: Firm

Motivation: IPO

In its IPO prospectus, USN highlights its niche in the increasingly successful business of reselling local telephone services. Soon after the IPO, USN discloses that reselling profit margins are thin, and it will shift its strategy to building its own network. S&P revises its outlook on USN to negative after the firm announces it will require additional capital to meet planned capital expenditures and to fund its operations. After failing to secure new capital, USN cuts 46% of its work force, sells most of its assets and files for Chapter 11. USN settles for \$44.7 million.

#### **Vesta Insurance Group**

01/29/1998 to 06/01/1998

Whistleblower: Industry regulator

Motivation: Smoothing earnings

Vesta announces an accounting change that will force it to adjust its 1997 statutory results after engaging in discussions with the Alabama Department of Insurance during its routine examination. The firm fires its CEO and CFO. After the completion of its internal investigation with outside legal counsel, Vesta announces it will restate earnings for 1993 to 1998, lowering net income by \$72.4 million. The Alabama Securities Commission and the SEC open investigations into the accounting problems, but conclude the inquiries without any actions. Vesta settles the class-action suit for \$61 million.

#### **Waste Management, Inc.**

06/11/1998 to 11/09/1999

Whistleblower: Firm

Motivation: Merger/Acquisition

Waste Management discloses that it misses projections by \$250 million with the claim that they mis-read the signals of decreased demand. Management fails to reveal that the much-touted integration with USA Waste and the price increase that quarter was resulting in customer attrition. During the class period, 3 executives sell \$57 million worth of stock and are later charged by the SEC. A second set of improprieties are later combined into a suit that settles for \$457 million.

#### **Waste Management, Inc.**

06/11/1998 to 11/09/1999

Whistleblower: Board

Motivation: Merger/Acquisition

Triggered by the \$250 million shortfall and by the class action suits concerning insider trading, Waste Management's board fires two executives, and soon thereafter the CEO, and conducts a massive investigation of accounting irregularities. Over 1,000 hired accountants tabulate \$1.2 billion in charges necessary to correct, primarily, over-valued fixed assets and accounts receivable. The SEC conducts a

full investigation, and Waste Management settles for \$457 million, in conjunction with a set of prior suits regarding insider trading.

**Westar Energy, Inc.: Common Stock and Western Resources Capital I Cumulative Quarterly Income**

03/29/2001 to 12/26/2002

Whistleblower: Industry regulator

Motivation: Personal profit

The Kansas Corporation Commission, the utility regulator, expresses concern that Westar has loaded too much non-utility, venture debt on its core electricity operations. The regulator halts plans by the CEO to sell off assets of the firm to a private company which, it is later revealed, that he would own. The CEO is found guilty of fraud and money laundering. Westar settles shareholder claims for \$33 million.

**Westell Technologies**

06/27/2000 to 10/18/2000

Whistleblower: Analyst

Motivation: Industry Downturn

An analyst lowers his recommendation of Westell based on the potential for a strike at customer Verizon and inventory in the channel at Westell's other large customer SBC. The latter prediction is accurate, a fact that Westell would have known; SBC purchases of Westell product occurs in lump shipments, not in continual flows as Westell suggests. During the class period, Westell insiders sell \$11 million worth of shares. Westell settles for \$4 million.

**Xcel Energy, Inc.**

01/31/2001 to 07/26/2002

Whistleblower: Industry regulator

Motivation: Smoothing earnings

The SEC and energy regulator's yet informal probes into the round-trip trades of Xcel encourage the firm to disclose to analysts the distressed nature of their energy trading division and that the firm had cross-collateralized the loans made to the trading unit. When the round-trip trades investigations comes to the fore, Xcel hires a new auditor to replace Arthur Andersen, lowers the prior two years financials by \$3 billion to reflect proper revenue recognition and closes its energy unit with a \$2 billion write off. Xcel settles shareholder suits for \$88 million.

**Xerox Corporation**

02/17/1998 to 06/28/2002

Whistleblower: Firm

Motivation: Smoothing earnings

Xerox's new CEO announces that certain isolated irregularities exist in Xerox's Mexico accounting. The Mexico accounts fail to reflect the extent of liabilities and fail to expense uncollectible receivables. Two prior years of earnings are adjusted downward by

\$400 million, and an SEC investigation ensues.

**Xerox Corporation**

02/17/1998 to 06/28/2002

Whistleblower: Employee

Motivation: Smoothing earnings

A former employee sues Xerox for wrongful termination after he reports more systematic accounting irregularities following Xerox's isolated accounting scandal in Mexico. In particular, the firm improperly books lease payments to current revenues and does not expense bad debts. The SEC begins an investigation, after which the firm restates earnings for four years and pays a fine of \$10 million.

**Xerox Corporation**

10/22/1998 to 10/07/1999

Whistleblower: Firm

Motivation: Industry Downturn

The restructuring plan of Xerox's new CEO not only fails to lift margins, but enables the firm to cloud the falling demand for its product. By the time the firm announces the shortfall in sales, insiders will have sold \$52 million in company stock during the year class period. The CEO resigns.

**XL Capital Ltd.**

11/01/2001 to 10/16/2003

Whistleblower: Firm

Motivation: Merger/Acquisition

Calling the period "among the worst" ever for casualty insurers, the CEO of XL Capital discloses the inadequacy of reserves in their newly acquired NAC Re segment. In addition to not maintaining adequate reserves, the firm fails to disclose that the reserve adjustment of \$184 million is only a fourth of the under-reserved position for the segment, which should have been known to the firm two years prior after the World Trade Center exposure to re-insurance.