6. Corporate governance and financial distress

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INTRODUCTION

How can providers of capital to corporations make sure that managers return some of the firm's profits? Once the investors have parted with their money, they have little more to contribute to the firm. What then prevents managers from expropriating the funds provided by investors? As a matter of fact, corporate insiders have access to an elaborate expropriation technology. For example, managers can sell the firm's output or assets at below-market prices to an independent firm they own, get subsidized loans, issue underpriced securities to themselves or their relatives or pay themselves excessive compensation.

Corporate governance is the set of mechanisms that regulate the actions of corporate insiders (managers and large shareholders) in order to protect the interests of outside investors (dispersed shareholders and creditors). Adequate protection of investor rights is necessary to induce outside investors to provide financing to the firm.

As reviewed in Shleifer and Vishny (1997), Bradley et al. (1999) and La Porta et al. (2000), the past decade has seen an explosion of academic research in corporate governance, most of it empirical. Topics covered include the value of the right to vote, the market for corporate control, agency issues, optimal financial and compensation contracts, accounting transparency, insider trading, insider board structures, and so on. This chapter reviews some of the issues and evidence specific to so-called corporate 'tunneling' and other fraudulent activities by corporate insiders. There is an emphasis on financial distress and I try to review issues of particular relevance to Sweden.

All available evidence is subject to a general econometric problem in terms of detecting the true relationship between corporate governance and firm performance, which is the ultimate variable of interest. It is precisely because of these econometric problems that the second-generation research requires better econometric procedures. Rather than discussing what these econometric improvements ought to be, this chapter focuses on the issues that need to be subject to additional research before firm conclusions can be drawn about the real impact of governance practices as well as the nature of an optimal governance system.

The chapter is organized as follows. The new section provides a general overview of corporate governance. Then I discuss tunneling and fraudulent transfers. A further section deals with the relationship between corporate governance and fraud, and a final section concludes.

CORPORATE GOVERNANCE AND INVESTOR PROTECTION

In this section I discuss different corporate governance mechanisms designed to ensure that the firm returns some of its cash flow to investors. I first review key features of the regulatory framework and then turn to the internal governance system set up by the firm itself.

The Regulatory Framework

Most advanced market economies provide a legal and regulatory system that protects the rights of outside investors reasonably well. From a legal perspective the corporate governance system consists of non-contractable laws, such as corporate, bankruptcy and securities laws that describe some of the rights of corporate insiders and outside investors, as well as contract law dealing with privately negotiated arrangements. Moreover, regulation governing disclosure and accounting rules is important to grant investors the information they need to exercise their rights.

In addition to the laws directly protecting investor rights, there is further regulation that defines the external governance forces on the firm provided by the market for corporate control, the managerial labor market and product-market competition.

Of equal importance to the regulation and laws themselves is their enforcement. An effective governance system requires these laws and contracts to be well enforced by regulators and courts as well as by the market participants.

Shareholder rights

The most important legal right of shareholders is their right to elect the firm's board of directors and to vote on important corporate matters, such as mergers and liquidations. However, while most common stock carries some voting rights, these rights may be expensive to exercise and to enforce. In many countries shareholders cannot vote by mail and have to show up in person at
the shareholder meeting to vote. Also, management control information and often interferes in the voting process.

Some countries have restrictions which specify that minority shareholders must be treated equally well as large controlling shareholders. Moreover, most OECD countries accept principles of managerial duty to act in shareholders' interest, placing legal restrictions on managerial self-dealing. The strictness with which courts enforce this duty of loyalty, however, varies substantially across countries.

When control rights are concentrated with a small number of large investors, concerted action is much easier than when control rights are split between many small investors. In effect, concentration of ownership facilitates legal protection and therefore corporate governance is often exercised by large investors. However, since large investors represent their own interest, which need not coincide with the interests of other investors in the firm, concentrated ownership has its own costs. There is a chance that large investors appropriate other investors and shareholders in the firm, particularly if their control rights are significantly in excess of their cash flow rights. They may do so by paying themselves special dividends or by exploiting other business relationships with the companies that they control. With the exception of the USA and the UK, large shareholdings are the norm in most countries (see, for example, La Porta et al., 1999).

Corporate governance systems vary greatly across countries. In the USA, both small and large shareholders are protected through an extensive system of rules that protects minority rights, allows for easy transfer of shares and keeps elections of directors relatively uninhibited by managers. Moreover, shareholders have executive powers to sue directors for violations of fiduciary duty, including through class action suits to get around the free-rider problem of dispersed share ownership.

In much of the rest of the world investors have unsatisfied needs for legal protection, either because laws provide poor protection or because courts do not enforce these laws. As a consequence, firms remain family controlled and, even in some of the richest countries, have difficulty raising outside funds. La Porta et al. (1998) show that companies in countries with poor investor protection have more concentrated ownership of their shares, perhaps because equity is less attractive to small investors in countries where their rights are poorly protected.

Creditor rights
Since defaults is a reasonably straightforward violation of a debt contract that can be verified in court, legal protection of creditors is often more effective than that of shareholders. Creditors' legal rights include, for example, the right to seize assets that serve as collateral for loans and the right to force the firm into bankruptcy when it fails to service its debts. In contrast to the enforcement of shareholder rights, creditors can act on their own against a failing debtor without taking coordinated action by multiple creditors.

The severity of the bankruptcy threat for the firm's owners and managers depends on the specific provisions of the bankruptcy code. Creditors in the USA have few rights relative to creditors in Germany and Japan. In US bankruptcy, managers and equity holders receive substantial protection from creditors. As with shareholders rights, the extent to which courts are willing to enforce the law is ultimately what determines the degree of creditor protection.

Sweden
In an international comparison of legal systems presented by La Porta et al. (1998) Sweden scores relatively low on the protection of shareholder rights. In Sweden, voting rights are not required to be tightly linked to cash flow rights and the law endorses shares with different voting rights. For example, the investment companies Investor and Investindustri are together control 67 per cent of the votes in the telecom giant Ericsson although they own only 7 per cent of the total shares outstanding. Swedish law provides relatively poor protection of minority shareholders against managers and dominant shareholders in the corporate decision-making process. That is, shareholders cannot proxy vote by mail and there are no procedures for proportional representation on the board and no provisions for cumulative voting for directors to grant minority shareholders representation on the board.

Moreover, there are no legal mechanisms for minority shareholders against perceived dominances by directors, including the right to challenge directors' decisions in court. Minority shareholders who object to certain fundamental decisions of management or the shareholder meeting, such as mergers or assets sales, lack the right to force the firm to repurchase their shares. On the other hand, in Sweden shares cannot be blocked before a shareholder meeting and shareholders have a pre-emptive right to buy new issues of stock. Perhaps as a result of the generally weak protection of minority shareholders, Swedish firms tend to be dominated by large shareholders.

In contrast to the relatively poor protection of small shareholders, creditor rights are well protected in Sweden. There is a legal reserve constraint, which requires the firm to maintain a minimum level of capital to avoid being forced into liquidation. In bankruptcy secured creditors are assured the right to collateral; and management has to hand over the control rights to a trustee with no option to seek protection from creditors in a reorganization procedure such as the US Chapter 11.

Importantly, according to La Porta et al. (1998), Sweden scores high in the enforcement of investors' legal rights in terms of an efficient judicial system.
contracts are designed to induce managers to act in shareholders' interests. To make incentive contracts work in practice, however, the performance measure determining managerial compensation must be highly correlated with the quality of the manager's decisions and his/her effort. If this correlation is weak, compensation programmes have little incentive effect. Over the last decade, an increasing portion of managerial compensation has been in the form of stock and options awards.

While the intention of stock-based compensation is to increase managers' focus on shareholder value by tying a substantial part of their personal wealth to the firm's stock price, there is a flipside as well. One problem is that stock-based programmes create opportunities for managerial self-dealing, allowing allocation of stock-option grants shortly before good news about the firm is made public. See, for example, Murphy (1998) for a review of the literature on executive compensation. Moreover, the recent demise of, for example, Enron, WorldCom and Tyco has prompted allegations that sizeable stock and option awards to top executives may generate an emphasis on short-term earnings and away managers to manipulate the earnings statements.

Financial contract design

The third component in the internal governance system is the design of the firm's differing financial contracts. For instance, firms often choose to issue only one class of common stock, even if the law allows shares with different voting rights. Shareholders can refuse the adoption to the corporate charter of shareholder rights plans or 'poison pills', which delegate excessive power to management to block a hostile takeover attempt. Creditors may demand restrictive covenants that protect them from large leverage increases or govern how fast creditors can gain control over the firm's decisions, were it to fail to sustain required financial ratios or default on its debt.

Failure of one or more of the internal governance mechanisms - internal monitoring, the incentive effect of executive compensation packages or the design of the firm's financial contracts - increase the risk of expropriation of outside investors by corporate insiders. Below I focus in particular on fraudulent transfers of funds, fraudulent financial reporting, which makes outside investors overpay for the firm's financial securities, and customer fraud.

EXPROPRIATION THROUGH FRAUDULENT TRANSFERS

This section discusses fraudulent transfers of funds from the firm. I first discuss transfers by controlling shareholders at the expense of minority
shareholders, so-called tunneling, and then turn to transfers that leave the firm insolvent, and thus reduce the assets left for creditors.

Tunneling

One mechanism by which corporate insiders can expropriate wealth is by selling the firm’s assets or output at below-market prices to a firm owned by the insider or his relatives, so-called tunneling of assets. The market value of services, intangible assets and technological innovations such as a software code can be particularly difficult to verify in court and therefore onerous to uncover for corporate outsiders. The risk of tunneling by controlling shareholders is higher in countries with poor minority shareholder protection and poor judicial efficiency.

Empirical evidence on tunneling

Systematic empirical evidence on tunneling is sparse. One exception is Ilie et al. (2002), who examine the prevalence of tunneling among acquiring firms in Korea. Many of the acquirers belong to large business groups, chaebols, where the ownership is concentrated with one individual who controls almost all firms within the group. The study shows positive abnormal announcement returns for non-chaebol bidders, while the returns are negative for chaebol-affiliated bidders that perform well prior to the acquisitions. Interestingly, the acquisitions by chaebol bidders have a significantly positive effect on the market value of the other firms in the chaebol. The results indicate that chaebol firms make takeover decisions that are beneficial only to controlling shareholders and support the view that acquisitions provide controlling shareholders with an opportunity for tunneling.

Similar results are found for business groups in India. In a study of the flow of resources between firms in the same group, Bertrand et al. (2000) suggest that a significant amount of tunneling is taking place.

Interestingly, Johnson et al. (2000) show that tunneling also occurs in countries with effective law enforcement and not just in emerging markets. They provide examples of judicial decisions in Belgium, France and Italy, in which the courts allowed substantial expropriation of minority shareholders. Johnson et al. (2000) posit that common law countries may prevent tunneling better than civil law countries because of a broader application of the duty of loyalty, a lower standard of proof in conflict of interest situations, less emphasis on stakeholder interests and more reliance on fairness to regulate self-dealing.

The value of voting rights

The incentive to transfer resources out of the firm increases when the controlling shareholder’s voting rights substantially exceed his cash flow rights. This is because the large shareholder now controls corporate decision making while his cost in terms of lost cash flow is relatively low. Voting rights deviate from cash flow rights when control is exerted through pyramidal structures and when there are several classes of common stock with different voting rights. The value of voting rights varies across countries, probably with the protection of minority shareholder rights and large shareholders’ opportunities to expropriate value. For a discussion of the value of voting rights of publicly traded firms see, for example, Leusie et al. (1983) and Zingales (1994).

Fraudulent Transfers by Financially Distressed Firms

If a transfer reduces corporate assets so that the firm is left insolvent, some of the costs of the expropriation will be borne by creditors. With financial distress and corporate default imminent, such wealth transfers can take the form of servicing selected debt claims that have little chance of recovery in a formal restructuring, for example, the repayment of a subordinate loan to a firm owned by the controlling shareholder or preferential payments to suppliers that are of continued strategic importance to the corporate insider. These payments circumvent the priority order of the firm’s debt and deprive senior and secured lenders of their source of repayment.

Fraudulent conveyance

When a fraudulent transfer leaves the firm insolvent, the transaction is typically legally voidable and the recipient can be forced to return the assets for satisfaction of the debt. In the USA the bankruptcy court can invalidate transfers made within 90 days prior to filing (within one year if the transfer involves corporate insiders). Fraudulent conveyance is a non-constructive legal rule which allows recovery from third-party transferees not parties to the debt contract. This law forbids all possible transactions where the borrower receives less than ‘reasonably equivalent value’ for the asset transferred and is insolvent after it occurs.

Heaton (2000) suggests that the fraudulent conveyance rule is a complement to private contracting that increases firms’ debt capacity. With private contracting only, the firm is unable to commit to not fraudulently transferring assets when such transfers are in the interest of corporate insiders and where proceeds can be shielded from the lender’s contractual remedy. The inability to commit will severely limit the firm’s ability to borrow, in particular when assets are highly liquid and therefore attractive for insiders’ use liquidate. This somewhat counter-intuitive result – that liquid assets may lower debt capacity – is referred to as the “paradox of liquidity” by Myers and Rajan (1998). The
Corporate governance and financial distress

In this chapter I provide some simple univariate statistics based on the sample of 263 privately held small Swedish firms filing for bankruptcy during 1988–91, examined by Thorburn (2000). Over a two-year period prior to filing, 30 firms (11 per cent) transferred major assets to another firm owned by the controlling shareholders. There are, however, insufficient data in the bankruptcy file to assess whether the transferred firm was adequately compensated or if these transfers reduced the assets available to creditors.

Fraudulent transfers by financially distressed firms

In Swedish bankruptcy the validation period for fraudulently transferred funds that leave the firm insolvent is typically 90 days, with two years to recover preferential transfers to corporate insiders. Information on allegations of fraudulent conveyance is available for 235 of the filings in Thorburn (2000). Charges of fraudulent transfers were made in a total of 53 cases (23 per cent), of which the funds were successfully recovered in two-thirds (38) of the alleged cases.

In a majority of the allegations (86 per cent) the transfer had been made to a controlling shareholder. The remaining cases involved preferential payments to suppliers and banks that bypassed the priority order of debts claims. The average size of funds recovered based on a fraudulent conveyance charge was SEK 606,000, which on average represented 7 per cent of the face value of total debt, with a maximum recovery of SEK 5.1 million, representing two-thirds of that firm’s total debt claims.

Auction prepacks

Upon bankruptcy filing in Sweden the firm is told in an auction, either piecemeal or as a going concern. Thorburn (2000) reports that one-quarter of the going concern cases are arranged just prior to filing, while the shareholders are still in control of the firm. In these instances, which she labels auction prepacks, the incumbent owner–manager negotiates a sale of the firm’s assets. The remaining corporate shell — with whatever assets are left, including the settlement for the going concern sale — subsequently files for bankruptcy.

The asset sale, which must be approved by the firm’s secured creditors (typically banks) and afterwards by the trustee, shortens the bankruptcy auction process and eliminates competition among bidders. For the majority of prepack sales (58 per cent) the buyer was another firm owned by the controlling shareholder. Thus it is possible that consortium shareholders use auction prepacks to tunnel resources out of the firm prior to declaring bankruptcy, reducing the assets left for creditors.

In only one case, however, did the trustee object to the transfer price and declare the transaction invalid. Moreover, Thorburn (2000) reports similar creditor recovery rates across auction prepacks and regular going concern transfers.

Secured debt

Secured debt provides a protection against fraudulent asset transfers by allowing the secured creditor to seize the collateralized assets from a third-party buyer. This contrasts with fraudulent conveyance law, which protects unsecured creditors as a group and gives no lender rights in specific assets. While secured debts to some extent can substitute for fraudulent conveyance law, the latter provides lenders with an enhanced protection. For example, it is practically impossible to take a security interest in all of a borrower’s assets. Moreover, secured debt contracts require continuous monitoring and are costly to write.

Empirical evidence on fraudulent conveyance

It is possible that the threat of invalidating transactions under fraudulent conveyance law reduces buyers’ willingness to acquire assets from firms in financial distress. This is, nevertheless, ample evidence of asset sales among distressed firms; see, e.g., example, Jha et al. (1992) and DeAngelo et al. (2002).

Dutta and Iskander-Dutta (1995) examine asset sales for a sample of firms filing for US Chapter 11 bankruptcy and find that 65 per cent of firms diversify assets over a two-year period prior to filing, while 63 per cent diversify assets after filing. They conclude that financially distressed firms sell off assets to the same extent before and after bankruptcy filing, and suggest that the provision for recovering assets due to fraudulent conveyance does not pose a serious impediment to divestitures during financial distress.

Fraudulent Transfers in Sweden

As discussed above, in Sweden the protection of minority shareholder rights is relatively weak, deviating from the principle of one-share-one-vote are common and ownership is typically concentrated. There is hence a non-trivial risk of expropriation of corporate resources by dominant shareholders.
Efficiency of the auction

If the liquidity in the bankruptcy auction is poor, buyers may purchase distressed assets at fire-sale prices; see, for example, Shleifer and Vishny (1992) and Pulvino (1998). Moreover, as in Strumvberg (2000), old owners may have an informational advantage about the value of assets and buy back the firm when the assets are undervalued. Eckbo and Thorburn (2002), in contrast, claim that the filing firm’s bank often has an incentive to finance a bidder in order to increase the liquidity in the auction. When the bank has an impaired debt claim on the filing firm, its payoff is increasing in the auction price. As a result, the bank’s optimal strategy is to provide liquidity and encourage overbidding.

Using a sample of Swedish bankruptcy auction cases, Eckbo and Thorburn (2002) show that the auction premium increases with a measure for the bank’s incentive to overbid, consistent with their model. Also, they find no evidence in support of assent-fire sales arguments. Importantly, the premiums paid in the auction when an old owner repurchases the firm are not significantly different from premiums paid by external buyers, providing little evidence that shareholders of filing firms can use the bankruptcy auction to expropriate creditors.

Areas for Future Research

The above discussion of expropriation through fraudulent transfers generates several interesting questions with reference to Sweden. First, given the relatively poor legal protection of minority shareholders, it is natural to ask whether controlling shareholders in Sweden tend to expropriate funds through tunneling. If this is not the case, what can explain a possibly low level of tunneling in Sweden? Are certain institutional characteristics or social norms related to governance different from other countries where the existence of tunneling has been confirmed? Or does the likelihood of tunneling depend on specific characteristics of the firm’s internal corporate governance system? If so, what measures can minority shareholders take to reduce the risk of expropriation?

A second issue is whether auction prepacks can be used by controlling shareholders to expropriate wealth from a financially distressed firm before creditors get to share whatever is left of the firm’s assets. This has potentially important implications for bankruptcy law and for how trustees should treat going concern sales of the firm’s assets that are secured just prior to filing.

Third, do firms undertaking fraudulent transfers that leave the firm insolvent display certain characteristics? For example, are allegations of fraudulent conveyance more common for firms with certain corporate governance characteristics? The identification of such characteristics could help guide junior creditors, for example, trade creditors, in taking preventive measures to avoid lower recovery in bankruptcy resulting from fraudulent transfers. Furthermore, there is little evidence showing to what extent fraudulent transfers are successfully recovered and why it is sometimes impossible to recover the transferred funds.

A fourth set of issues relates to the possibility of substituting recovery based on fraudulent conveyance with the security provided by collateral. In particular, it is possible that fraudulent conveyance law plays a less prominent role in countries that allow floating-charge claims (for example, Sweden or the UK) and where basically all the firm’s assets can be pledged as collateral, compared to countries where only fixed assets are used as collateral (for example, the USA).

CORPORATE GOVERNANCE AND FRAUD

The firm’s corporate governance system and, in particular, the oversight of the board of directors may be important in preventing fraud. For example, outside directors are more likely to act independently of management and to be more efficient monitors that inside directors. Moreover, the level of stock ownership by outside directors is expected to align their incentives with shareholders, thereby improving their monitoring.

Evidence on Governance Characteristics and Fraud

In the USA, auditors are required to assess the risk of fraudulent financial reporting. The Statement on Auditing Standards (SAS) No. 61, ‘Consideration of Fraud in a Financial Statement Audit’ identifies 25 risk factors (red flags) that should be considered by auditors when making a fraud risk assessment. These risk factors include characteristics of the firm’s management, operating and financial stability as well as industry conditions.

Interestingly, auditors perceive management characteristics to be crucial in the evaluation of the probability of accounting fraud. Specifically, Apostolos et al. (2001) observe that auditors tend to give most weight in their fraud assessment to red flags, indicating that managerial compensation contracts are tied to aggressive accounting standards and managerial "bad attitudes" to financial control.

Several studies show that board independence and incentives matter for the incidence of financial fraud. Beasley (1996) finds that the likelihood of
Financial statement fraud decreases with the proportion of outside directors on the board and with the fraction of stock ownership of outside directors. Dechow et al. (1996) show that firms are more likely to be subject to accounting enforcement actions by the Securities and Exchange Commission (SEC) for alleged violations of Generally Accepted Accounting Principles (GAAP) when the board is dominated by company insiders, the CEO is also chairman of the board and the CFO is the firm’s founder. They also find a higher incidence of enforcement actions in the absence of an audit committee or external blockholder monitor management.

Examining whether multiple board assignments inhibit directors’ ability to monitor, Ferri and Lee (2000) find no relation between the number of directorships held by board members and the likelihood of securities fraud litigation against the firm.

While large shareholders may not own small shareholders, they also have strong incentives to actively monitor the firm’s management. Greer and Lehne (1997) show that a higher level of equity ownership across directors, and specifically concentration of ownership in one individual board member, reduces the probability of accounting fraud. Moreover, fraud is more likely when the firm’s assets are difficult to value, for example, due to high R&D or substantial intangible assets. Alexander and Cohen (1999) report that corporate crime occurs less frequently when management has a larger ownership stake in the firm. They further find that corporate crime is more likely the longer the tenure of the CEO, perhaps because tenure is a proxy for CEO entrenchment.

Firms disclosing alleged illegal corporate activities experience significant stock-price declines. Karpoff and Lott (1993) report an average two-day abnormal stock-price decline of 3.6% per cent when corporate fraud allegations are announced, with an average stock-price decline of −4.7% per cent for allegations of financial reporting fraud. These stock-price declines may reflect the present value of lost quasi-rents established through repeated contracting, for example, in the form of lower future prices on the firm’s output or financial securities. See also, for example, Strachen et al. (1983) and Alexander (1999) for further evidence of negative announcement returns from the disclosure of potential fraud.

The impact of fraud revelation on turnover of top executives and directors of the board is studied by Agrawal et al. (1999) for a sample of US firms suspected of or charged with criminal fraud. Fraud scandals can create incentives to replace incumbent managers in an attempt to improve firm performance, restore reputation or limit the exposure to liabilities arising from the fraud. The revelation of fraud may also create incentives to change the composition of the firm’s board in order to improve monitoring, or gain access to valuable reputation of new directors.

Controlling for performance and other firm characteristics, Agrawal et al. (1999) find little systematic evidence that fraud allegations lead to a higher turnover among senior managers or directors. Greer and Lehne (1997), however, show a significant decline in the number of other directorships held by directors of firms charged with accounting fraud compared to directors of control firms, suggesting that the incidence of fraud may negatively affect directors’ reputation for monitoring.

Fraud and Financial Distress

For a given level of monitoring, it is conceivable that fraud is more prevalent among poorly performing firms. Similar to the shareholder risk shifting incentives in Jensen and Meckling (1976), the threat of imminent failure may provide incentives for management to take excessive risks in an attempt to stay out of bankruptcy. That is, if managers face substantial personal cost as the firm fails, they may prefer short-sighted fraudulent actions—e.g., manipulation of the firm’s financial statements—to avoid bankruptcy filing. As shown by Maksimovic and Tiemann (1991), shareholders of a distressed firm may have incentives to cut costs and reduce the quality of the firm’s products to avoid immediate bankruptcy.

There is little empirical work examining how financial distress affects the incidence of corporate fraud. One notable exception is a study by Alexander and Cohen (1996), which fails to establish a relation between the probability of sentencing for US Federal crimes and the firm’s preceding three-year industry-adjusted growth rate in earnings (EBIT).

Evidence on Sweden

Aghion et al. (1992), White (1996) and Hart (2000) warn that shareholder incentives to “go for broke” by taking excessive risks are particularly pronounced when the bankruptcy procedure treats management harshly, that is, when the firm is auctioned off.Echo and Thorburn (2003), on the other hand, argue that managers care about the chance of getting rehired by the buyer in an auction, allowing them to maintain private benefits of control. In their model, the existence of private benefits may induce managerial expropriation, counteracting shareholder risk-shifting incentives. Based on a sample of firms filing for auction bankruptcy in Sweden, they present empirical evidence consistent with the notion that private control benefits mitigate risk-shifting incentives for financially distressed firms.

In Thorburn’s (2000) sample of Swedish bankruptcies, 261 cases contain information on whether or not the trustee discovered fraudulent accounting practices or suspected economic criminal activities. Fraudulent accounting practices were found for a total of 61 firms (23 per cent) and allegations of
economic crime were made in 53 cases (20 per cent). The Pearson correlation between these two events is 0.52, which is statistically significant (p<0.001).

While I lack comparable numbers for non-bankrupt firms in Sweden, the incidence of accounting fraud and economic crime for bankrupt firms appears relatively high.

Interestingly, the likelihood of piece-meal liquidation is somewhat higher for firms with fraudulent accounting practices, with 30 per cent of these firms sold piecemeal versus 20 per cent for non-fraud firms. Moreover, it is more common that a creditor files the bankruptcy petition when the firm was engaged in financial fraud (25 per cent versus 4 per cent for non-fraud firms), or alleged with economic crime (31 per cent versus 4 per cent for non-alleged firms).

The higher incidence of piece-meal liquidation and the lower tendency to 'voluntarily' file for bankruptcy both indicate that owners and managers of firms involved in fraudulent reporting or other criminal activities may be less inclined to rescue any remaining going concern value. Not surprisingly, these firms also report significantly lower creditor recovery rates, measured as the payoff to creditors divided by face value of total debt, than non-fraud and non-crime firms. The recovery rate of firms charged with fraudulent accounting practices averaged 29 per cent (median 21 per cent) compared to an average recovery rate of 38 per cent (median 37 per cent) for non-fraud firms. The corresponding rate for firms with alleged economic crime was an average of 27 per cent (median 26 per cent).

Areas for Future Research

As discussed above, a relationship between corporate governance characteristics, such as the monitoring efficiency of the board and the occurrence of fraud, has been demonstrated for publicly traded firms. However, evidence is sparse on the importance of different governance characteristics for small, privately held firms. For example, why would a dominant shareholder who basically owns the entire firm encourage accounting fraud? Whom is he fleecing? Is the board of directors of a small, closely held firm sufficiently independent to actively monitor in order to prevent fraud?

In the absence of dispersed shareholders, the motivation for financial statement fraud may be to expropriate or hold off banks and other creditors, including tax claims. If so, it is possible that outside financial distress, small closely held firms are less likely to commit financial accounting fraud than large, widely held firms. However, it remains to establish whether the incidence of fraud indeed is higher for financially distressed firms compared to non-distressed firms, both among publicly traded and privately held firms.

Although the frequency of fraudulent accounting and economic crime allegations may seem high for firms in Swedish bankruptcy, it is possible that the probability of discovery simply is greater in bankruptcy since the firm's books are opened up to an outside independent trustee.

Given the generally lower recovery rate for creditors when the firm is alleged with fraudulent accounting or economic crime, these activities seem to impose substantial costs on creditors. One set of issues in need of further research relates to whether creditors can protect themselves from expropriation through fraud by monitoring certain firm and management characteristics. What characterizes firms charged with accounting fraud or economic crime, for example, in terms of governance characteristics and ownership structure? Does the structure of the firm's debt matter, for example, and does secured debt reduce the opportunity for management to expropriate assets?

CONCLUSIONS

Corporate governance is a set of mechanisms designed to ensure that corporations return some of their profits to outside investors. Shareholder and creditor rights are enforced through the different features of a country's laws and regulations. Moreover, firms design internal governance systems consisting of board oversight (monitoring management), executive compensation (providing incentives) and financial contracts (allocating rights between the firm's security holders). A transparent and stringent accounting practice helps provide investors with the information necessary to take actions.

Finally, an effective governance system requires strict enforcement of contracts and regulation by regulators, courts and market participants. Failure of one or more of the governance mechanisms increases the risk of expropriation by corporate insiders.

Corporate insiders can expropriate wealth by selling assets or issuing securities at below-market prices to a firm controlled by the insider. The risk of sponsoorship by controlling shareholders is higher in countries with poor protection of minority shareholders but seems to exist also in civil law countries with efficient court systems. When the transfer of assets leaves the firm insolvent, funds can be recovered through fraudulent conveyance law. Thus fraudulent conveyance law increases the firm's debt capacity, complementing the use of secured debt.

In one-quarter of the firms in Thorburn's (2000) sample of Swedish bankruptcy filings the trustee tried to recover funds based on fraudulent conveyance law. Moreover, there is a possibility that auction prepacks where the firm's assets are sold to another firm owned by the controlling shareholder
are used to expropriate creditors. Improved knowledge of the characteristics of
the governance system of firms undertaking fraudulent transfers of assets
could help creditors monitor more efficiently.

Extant research has established a relationship between board characteristics
and the occurrence of fraud for publicly traded firms. The more independent
the board of directors, the better monitoring it provides and the lower is the
incidence of corporate fraud. It is conceivable that corporate fraud is more
common for financially distressed firms. The firm and its manager-owners
have much at stake in a bankruptcy filing, which increases the incentives to
gamble in an attempt to stay out of bankruptcy, for example, by fraudulent
reporting. However, the empirical evidence on this issue is sparse, creating
demand for more research on fraud and financial distress.

NOTES
1. This chapter was prepared for the Linkoping International Conference on Economic Crime,
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the Swedish National Council for Crime Prevention (BRÅ) for partial financial support.
2. The ownership information is per year-end 2001, and the source is SIS Agerevius AB.
3. In 2000, Eurec’s board approved bonuses of $790 million to senior managers and officers,
compared with total corporate profits of $915 million.

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Paul Webley

INTRODUCTION
The Meaning of "Tax Compliance"

Tax compliance is a deceptively straightforward term. There are tax rules (for example VAT laws, regulations on corporation tax filing) and businesses that follow the rules are showing tax compliance. Those that don’t are non-compliant. But there are some legal and conceptual distinctions that must be borne in mind at the outset. Social scientists tend to use the terms ‘tax evasion’, ‘tax fraud’ and ‘tax non-compliance’ interchangeably. A search through the literature shows that they favour the first (probably because the deliberate breaking of rules is more theoretically tractable) but this is inappropriate. Tax authorities and tax agencies very clearly prefer the term ‘compliance’.

So it is appropriate to begin with some definitions. In the UK (and in most jurisdictions) there is a legal distinction between tax evasion and tax avoidance. Tax evasion is illegal. It involves deliberately breaking the law in order to reduce the amount of tax paid. It can involve acts of omission (for example failing to report certain assets to the tax authorities) or commission (for example, falsely reporting personal expenses as business expenses). Tax avoidance is not illegal. It involves every attempt by legal means to reduce tax liability which would otherwise be incurred by taking advantage of some provision or lack of provision in the law ... it presupposes the existence of alternatives, one of which would result in less tax than the other (Royal Commission on Taxation, 1966, p. 530). Tax compliance is a more neutral term. A business may fail to comply with the tax rules for a multitude of reasons but this does not mean that the owners or managers have broken the law. A business owner may simply not understand a tax form or aspects of the tax paying procedure; he or she may misuse or misuse the tax deductibility.

These distinctions are legalistic or commonsensical. Following McMarnet