

CORPORATE GOVERNANCE FAILURES—IS PARMALAT EUROPE’S ENRON?

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I. INTRODUCTION

As the Enron scandal unfolded in early 2002, some European investors felt vindicated. They deplored the greed of American executives, and many of them thought that such a scandal could never occur in Europe.¹ But sure enough, just as American movies reach European theaters after a delay of several months, Europe got its corporate scandal: Parmalat, a corporate debacle comparable in size and intricacy to its major U.S. rivals, and thus quickly dubbed “Europe’s Enron.”²

Parmalat S.p.A. (hereinafter, collectively with its subsidiaries and associated entities, “Parmalat” or “the Group”) started in 1961 as a family run store in the small town of Collecchio, near the city of Parma, Italy. By mid-2003, Parmalat was a well-reputed international food and dairy giant with a presence in more than thirty countries and with some 36,000 employees.³ For the year 2002, Parmalat declared €7.721 billion in revenues and EBITDA of €931 million.⁴ In spite of a decrease in operating profits for

¹ Mark Landler, *Scandal Outrages Europeans; Solutions May Be Patchwork*, N.Y. TIMES, Dec. 25, 2003, at C1.

² *The Pause After Parmalat – The Response to Parmalat*, ECONOMIST, Jan. 17, 2004, at 13, available at http://www.economist.com/displaystory.cfm?story_id=S%27%298%20%29PQ%3F%25%20%20%22X%0A&tranMode=none.

³ *Parmalat, un'azienda con 36mila dipendenti*, REPUBBLICA (Rome), Dec. 19, 2003, available at <http://www.repubblica.it/2003/l/sezioni/economia/parmalat/parmascheda/parmascheda.html>.

⁴ PARMALAT FINANZIARIA S.P.A., CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEAR ENDED DEC. 31, 2002 69-70 (2003), available at http://www.parmalat.net/en/doc/Consolidated_financial_statements_as_at_December_31_2002.pdf [hereinafter 2002 FINANCIALS]. The EBITDA figure can be calculated by adding the “Trading Profit” figure on page 69, which corresponds to Earnings Before Interest and Taxes (“EBIT”), to the “Depreciation, amortization, and write-downs” figure (“DA”) on the same page, ignoring the provision for doubtful accounts included under the latter heading, because that is actually an operating expense and not

the third quarter of 2003, Parmalat's financial statements portrayed a rosy picture of a firm in solid financial health.⁵ With €4.2 billion in cash and cash equivalents recorded on its books, the eighth largest Italian company⁶ was considered to be one of Italy's few industrial success stories.

All appeared to be well until December 9, 2003, when a three-line fax sent by Bank of America ("BOA") to Parmalat's auditors, Grant Thornton, opened the floodgates on what the U.S. Securities and Exchange Commission ("SEC") properly deemed "one of the largest and most brazen corporate financial frauds in history."⁷ The fax, requested by Grant Thornton under pressure from C.O.N.S.O.B., the Italian equivalent of the SEC, revealed that Parmalat had forged documents attributing to the firm a €3.9 billion (\$4.769 billion)⁸ liquid account with BOA.⁹ Thus, €3.9 billion of the €4.2 billion in cash and cash equivalents declared by Parmalat had simply never existed.

And the fax from BOA was just the tip of the iceberg. When PricewaterhouseCoopers LLP ("PwC") attempted to determine the real financial status of the company in January 2004, it reported net debt of approximately \$17.5

depreciation/amortization. For 2002, EBIT was €595,700,000 and DA was €335,700,000 (minus the provision for doubtful accounts). EBITDA therefore was €931,270,000.

⁵ See PARMALAT FINANZIARIA S.P.A., DIRECTORS' REPORT ON OPERATIONS FOR THE THIRD QUARTER OF 2003 5 (2003), available at <http://www.parmalat.net/en/doc/Directors%20report%20third%20quarter%20sept03.pdf> [hereinafter DIRECTOR'S THIRD QUARTER 2003 REPORT].

⁶ Editorial, *Got Milked?*, N.Y. TIMES, Jan. 10, 2004, at A12.

⁷ SEC Charges Parmalat with Financial Fraud, Litigation Release No. 18,527, 81 SEC Docket 3143 (Dec. 30, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18527.htm> [hereinafter SEC Charges].

⁸ On December 9, 2003, the exchange rate of the U.S. dollar to the euro was 0.81780. Historical foreign exchange rates are available at <http://www.oanda.com/convert/fxhistory>. This rate will be used throughout the article to convert euro figures into U.S. dollar figures where specific sources do not otherwise provide such conversions.

⁹ Mario Gerevini, *Parmalat, ecco il fax che segno' la fine di Tanzi*, CORRIERE DELLA SERA (Milan), Dec. 18, 2004, at 14. See also SEC Charges, *supra* note 7, at 1.

billion (nearly \$16 billion of which had never been disclosed before), and earnings of only one-fifth the amount originally reported by the company.¹⁰

Just as U.S. investors had been left aghast in the wake of the Enron scandal, European investors are now asking themselves how a fraud this large could have occurred and how it could have gone undetected for so long. Not surprisingly, given the bad reputation of Italy's corporate governance system,¹¹ some members of the media were quick to label the causes of the Parmalat scandal as country-specific.¹² But while the Parmalat debacle is characterized by some typically Italian or European aspects, it also displays some striking similarities to the Enron scandal and other egregious examples of gatekeeper failure.¹³ Understanding the differences and similarities between the Parmalat and Enron scandals can shed light on the ways in which corporate governance systems across the world could be improved.

Many factual issues regarding the Parmalat fraud still need to be resolved by forensic accountants and courts. In spite of the uncertainty surrounding many details of the scandal, this Note is an attempt to make sense of the Parmalat debacle using academic and journalistic accounts

¹⁰ Alessandra Galloni, *Scope of Parmalat's Problems Emerges*, WALL ST. J., Jan. 27, 2004, at A3. Galloni actually reports that PwC estimated Parmalat's net debt to be \$18 billion. The disparity between the \$17.5 billion figure and the \$18 billion reported by Galloni is probably due to the use of different exchange rates.

¹¹ See generally Jonathan R. Macey, *Italian Corporate Governance: One American's Perspective*, 1998 COLUM. BUS. L. REV. 121 (1998).

¹² Andrea Melis, *Corporate Governance Failures: To What Extent is Parmalat a Particularly Italian Case?*, 13 CORP. GOVERNANCE 478, at 478 (2005). Melis provides an interesting analysis of Parmalat's corporate governance failures and delves into the failures of the Italian regulatory system in much greater detail. For examples of journalistic accounts dubbing Parmalat a particularly Italian scandal, see Richard Heller, *Parmalat: A Particularly Italian Scandal*, FORBES, Dec. 30, 2003, available at http://www.forbes.com/2003/12/30/cz_rh_1230parmalat.html.

¹³ John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 305 (2004).

of the events, publicly available financial data, depositions of some of the major Parmalat officials, and some of the complaints filed in the Southern District of New York against Parmalat, its auditors, and other parties who allegedly participated in the transactions under investigation. This Note also tries to compare the events that led to the Parmalat fraud with those that prompted the Enron scandal. The ultimate goal is to understand whether frauds that took place under these different regulatory systems may have been caused by similar gatekeeper and corporate governance failures. Although this Note does not attempt to propose remedies to these problems, it does provide a starting point for academic discussions of potential normative remedies.

This Note is divided into five main sections. Part II is a summary presentation of the events that led to the scandal, from the humble origins of Parmalat to its notorious downfall. Part III provides an account of the means used to perpetrate the fraud. Part IV delves into the reasons for the scandal and how corporate controls failed in the Parmalat case as compared to the Enron case. Finally, Part V concludes the paper with a general thematic overview and an attempt to answer the following question: How could such a big scandal have gone undetected for so long when so many professionals were, or should have been, aware of it?

II. THE EVENTS THAT LED TO THE SCANDAL

Parmalat was founded in 1961 in the town of Collecchio, near Parma, Italy, a town renowned worldwide for its ham and its "Parmesan" cheese. Parmalat's founder, Calisto Tanzi, was the son of a ham and tomato paste merchant and had grown up in the food trade.¹⁴ Tanzi's new business focused on the sale of milk.

Parmalat's first expansion occurred in the mid-1960's, driven by the development of a new Swedish pasteurization technique known as "Uht." Uht milk has a shelf life of

¹⁴ Alessandra Galloni & Yaroslav Trofimov, *Behind Parmalat Chief's Rise: Ties to Italian Power Structure*, WALL ST. J., Mar. 8, 2004, at A1.

several months even without refrigeration and thus can be exported cheaply and easily to distant destinations.¹⁵ Under Tanzi's leadership and thanks to the success of Uht milk, Parmalat successfully competed for market share with other Italian milk producers. In its first ten years, Parmalat's gross earnings grew by 50% annually.¹⁶ In 1974, the company launched a joint venture for the production of yogurt in South America, which marked the first in a long series of Parmalat's industrial ventures in South America.¹⁷

By the mid 1970s, Parmalat had also initiated an aggressive marketing campaign that would continue throughout the 1990s. In addition to more traditional forms of advertising, Tanzi had been one of the first entrepreneurs to exploit sporting events for marketing ends: the Parmalat logo appeared at ski events, baseball games, Formula One races, and soccer matches.¹⁸ In 1990, Tanzi even realized the dream of every Italian businessman—he purchased his own soccer team, Parma A.C., which competed in the first division of the Italian soccer league (Parma A.C. would subsequently prove to be another drain on Parmalat's resources).¹⁹

By 1988, Parmalat was still closely-held by the Tanzi family, and Fausto Tonna had been named the new CFO (Tonna, along with Tanzi, has confessed to being a major player in the fraud). Under Tanzi's and Tonna's leadership, Parmalat substantially expanded its operations, yet it was not in good financial health. Although Parmalat had been able to make a name for itself by producing and exporting

¹⁵ *See id.*

¹⁶ GABRIELE CAPOLINO ET AL., *PARMALAT: LA GRANDE TRUFFA* 29 (Milano Finanza 2004). This book, which provided a substantial amount of the background information contained in this Note, is an extremely comprehensive journalistic account of the events that led to the Parmalat scandal. It was published by one of the most reputable Italian financial newspapers a few months after the fraud was discovered.

¹⁷ *Id.*

¹⁸ Galloni & Trofimov, *supra* note 14, at A1; *see also* CAPOLINO ET AL., *supra* note 16, at 74.

¹⁹ CAPOLINO ET AL., *supra* note 16, at 80, 86.

milk, it had made the mistake of entering too many new markets, all of which were extremely competitive and thus offered low profit margins. These lower margins, combined with the considerable spending required to develop and advertise these new products, decreased the company's profitability.²⁰ In the meantime, even the profit margins on sales of milk decreased, while Parmalat's debt increased.²¹ Given Parmalat's financial weakness, when, in 1988, U.S.-based Kraft Foods approached Tanzi to discuss a possible acquisition, it seemed as though Tanzi was destined to sell the company.²²

Nevertheless, Tanzi refused to sell, claiming that he desired to keep his company "wholly Italian."²³ To ensure Parmalat's continued survival, Tanzi needed a substantial infusion of capital to pay back the company's short-term debts. Tanzi therefore resorted to the public markets and conducted a reverse merger. In September 1989, Tanzi bought 51% of FinanziariaCentroNord ("Fcn"), whose stock was publicly traded on the Milan Stock Exchange. Fcn then bought 55.4% of Parmalat from Tanzi, after which Fcn increased its equity capital through a private placement. The financing obtained via the private placement was used to pay for the acquisition of Parmalat.²⁴ By October 1990, Fcn was renamed Parmalat Finanziaria and controlled 70% of the original Parmalat (Parmalat S.p.A.). This operation represented a treble success for Tanzi: first, the private placement had allowed him to acquire funds the firm desperately needed while maintaining control of the company (Tanzi remained the majority shareholder); second, conducting a reverse merger with a publicly-traded entity

²⁰ *Id.* at 55.

²¹ *Id.* at 53.

²² According to some sources, the company was technically insolvent at that time. Paolo Biondani & Marisa Fumagalli, *Il Procuratore: Alcune Banche Sapevano Dall'Aprile 2003*, CORRIERE DELLA SERA (Milan), Dec. 19, 2004, at 14.

²³ Galloni & Trofimov, *supra* note 14, at A1.

²⁴ For a description of the reverse merger, see CAPOLINO ET AL., *supra* note 16, at 58-65.

was less costly than taking Parmalat public itself; and third, and probably most importantly, the chosen procedure required much less disclosure of information regarding Parmalat's financial status.²⁵

Nonetheless, the availability of new financing could also be seen as the source of the company's problems. Given the precarious condition of Parmalat's operations in 1988, it would have seemed reasonable to modify the business strategy of the company by focusing on its core dairy products operations and attempting to cut costs. Instead, the inflow of new funds allowed Tanzi to hide Parmalat's financial problems by undertaking a plethora of ever more forceful and uncontrolled expansion schemes.

The 1990s marked Parmalat's rise to international recognition. After the company went public, Tanzi and Tonna decided to embark on an aggressive series of acquisitions that established Parmalat as a food and dairy powerhouse around the world. The ambitious goal of Parmalat's management was to "become the Coca-Cola of milk."²⁶ Yet Parmalat's expansion was not limited to food and dairy products; it included drinking water, sports, and tourism businesses. By 1994, the company had acquired or begun operations in Spain, Portugal, Germany, Russia, Brazil, and California.²⁷ In 1995, Tanzi targeted the U.S. market, focusing specifically on New York. By introducing the long-lasting Uht milk, Parmalat's management set the ambitious goal of acquiring 10% of the U.S. market share by the year 2000, though this plan eventually failed.²⁸ By 2003, Parmalat had targeted emerging markets as well, boasting operations in thirty different countries across five continents.²⁹ Overall, during the period from 1990 to 2003, Parmalat grew from a declared €500 million in revenues in

²⁵ *Id.*

²⁶ Galloni & Trofimov, *supra* note 14, at A1.

²⁷ CAPOLINO ET AL., *supra* note 16, at 67-69.

²⁸ *Id.* at 74-75.

²⁹ See Parmalat in the World, <http://www.parmalat.net/en/fset.html?sez=ab> (last visited Nov. 6, 2005).

1990 to €7.721 billion in 2002.³⁰ Although actual 2002 revenues amounted to only €6.2 billion, according to PwC's subsequent restatements, Parmalat had still managed to grow twelvefold since 1990.³¹

However, this unrestrained expansion ultimately led to the company's financial troubles. One of the problems with Parmalat's strategy was that targeting emerging markets necessarily entailed higher risk.³² And while Parmalat was quickly expanding into new markets with questionable prospects for success, its profit margins were decreasing in Italy, Europe, and especially South America.³³ Coupled with poor business judgment, the acquisition streak led to the company's combination of ever-increasing debt, lack of (real, though not declared) liquidity, and shrinking, if not negative, profitability (also actual, though not declared as such).

Additionally, as Parmalat accumulated debt to finance its expansion, the Parma A.C. soccer team³⁴ and struggling tourism firm, Parmatour,³⁵ further drained the company's accounts.³⁶ It is important to note that although Parmatour

³⁰ CAPOLINO ET AL., *supra* note 16, at 67. See also 2002 FINANCIALS, *supra* note 4, at 69.

³¹ CAPOLINO ET AL., *supra* note 16, at 67.

³² *Id.* at 76.

³³ The financial crisis of the late 1990s exacerbated the decline in sales in South America. *Id.*

³⁴ *Id.* at 83-86.

³⁵ The Tanzi family owned more than one tourism firm. Tanzi initially developed Parmatour for his daughter, Francesca, but it was only one of a series of tourism businesses. Nevertheless, for the sake of simplicity, this Note will use "Parmatour" generally to refer to the collective tourism firms owned by Tanzi.

³⁶ When asked about the tourism sector and Francesca Tanzi's role in it during a recent interview, Fausto Tonna, Parmalat's CFO, replied, "It is true, I had to act a bit as the babysitter for Francesca, Tanzi's daughter, who was incompetent but pretended to be in charge [of the tourism firm]. But when Calisto [Tanzi] offered me the chance to become President of the tourism firm, I rejected . . . [Financially, the tourism firm] was not a hole, it was a canyon." Marisa Fumagalli, *Tonna: Ho Bisogno Di Soldi, Nessuno Mi Fa Lavorare*, CORRIERE DELLA SERA (Milan), Dec. 18, 2004, at 14. Francesca, along with her brother Stefano, was arrested by Italian authorities on February 17, 2004. She was freed on March 8, 2004 after

was owned by Tanzi, it was not a subsidiary of Parmalat, nor did it have any formal ties to it.³⁷ Later, Tanzi confessed to siphoning off €638 million³⁸ from Parmalat for the benefit of Parmatour.³⁹ On the basis of the depositions of Tanzi and Tonna, as will be explained in Part III, it appears that Parmalat transferred its credits from Parmatour to the Parmalat Group's "money laundering" special purpose entities ("SPEs"), or "accounting dumps," from which they would disappear without leaving a trace.⁴⁰ As a result Parmatour received its funds, but Parmalat's books would not formally reflect the transaction.

Tanzi's strategy was to continue expanding and borrowing.⁴¹ In fact, to finance his distressed yet growing empire, Tanzi had to continuously turn to banks for funds, or to the market through bond, stock, and private placement offerings. During the 1990s, Parmalat became one of the favorite clients of major investment banks around the world. Virtually all of the biggest banks in the world did business with Parmalat, including Citigroup Inc., Merrill Lynch & Co., Bank of America Corp., J.P. Morgan Chase & Co., UBS

she had been exonerated of evidence tampering charges. She still faces fraud charges. *See Il Tribunale Del Riesame Ha Scarcerato Francesca Tanzi*, REPUBBLICA (Rome), Mar. 8, 2004, available at <http://www.repubblica.it/2004/b/sezioni/economia/parmalat11/scarcer/scarcer.html>.

³⁷ CAPOLINO ET AL., *supra* note 16, at 93.

³⁸ *Daughter of Founder of Parmalat Is Freed; Role Found Marginal*, WALL ST. J., Mar. 9, 2004, at B4.

³⁹ Prosecutors believe the amount to be closer to €1.5 billion. Melis, *supra* note 12, at 487 n.2.

⁴⁰ CAPOLINO ET AL., *supra* note 16, at 93. At the beginning of 2004, Parmatour was also declared insolvent. Bankruptcy authorities have decided to disregard the fact that Parmatour was not formally a Parmalat subsidiary and have joined Parmatour in Parmalat's bankruptcy. *Id.* at 97.

⁴¹ *See* Peter Gumbel, *How It Went Sour*, TIME, Dec. 13, 2004, at A2, available at <http://www.time.com/time/globalbusiness/article/0,9171,880285-1,00.html>. *See infra* Part III for discussion of why Parmalat had to "keep expanding to be able to keep borrowing."

AG, and Credit Suisse First Boston, just to name a few.⁴² According to a report by Enrico Bondi, Parmalat's special administrator in bankruptcy, Parmalat raised €13.2 billion from outside sources between 1990 and 2003. Of this amount, Parmalat received €4.1 billion from Italian and foreign banks and €7.4 billion from bond investors.⁴³ According to the SEC, approximately \$1 billion of the latter came from debt securities issued in the United States.⁴⁴

At the height of the South American crisis, Tanzi and Tonna became concerned that if investors knew the true financial status of the company, they would not provide Parmalat with the funds it needed so desperately. To convince the market to lend Parmalat more money, they believed that investors would have to be reassured about the financial health and stability of the company. Consequently, Tanzi and his fellow managers began making major adjustments to Parmalat's financial books, painting a far rosier picture for the market than the facts warranted.⁴⁵ In addition to forging transactions to create fictitious accounts receivable that they could record as assets, an SPE called

⁴² David Reilly & Alessandra Galloni, *Spilling Over: Top Banks Come Under Scrutiny For Role in Parmalat Scandal*, WALL ST. J., Sept. 28, 2004, at A1.

⁴³ Alessandra Galloni & David Reilly, *How Parmalat Spent and Spent*, WALL ST. J., July 23, 2004, at C1.

⁴⁴ First Am. Compl. at 1, SEC v. Parmalat Finanziaria S.p.A., No. 03-CV-10266 (PKC) (S.D.N.Y. July 2004), available at <http://www.sec.gov/litigation/complaints/comp18803.pdf> [hereinafter SEC First Amended Complaint]. Immediately upon the filing of the first amended complaint, Parmalat consented to a final judgment settling the action. See SEC Alleges Additional Violations by Parmalat Finanziaria, S.p.A., and Simultaneously Settles Civil Action, Litigation Release No. 18,803, 2004 SEC LEXIS 1631 (July 28, 2004). The fact that Parmalat was able to issue so many securities in the United States necessarily raises some serious concerns about the effectiveness of the American securities regulatory system.

⁴⁵ CAPOLINO ET AL., *supra* note 16, at 110. According to evidence filed with Italian judicial authorities and Tonna's deposition, Parmalat had tinkered with its books since 1995. See SEC First Amended Complaint, *supra* note 44, at 4.

"Bonlat" played a key role.⁴⁶ Bonlat was used to hide the losses emanating from Parmalat's industrial operations and to conceal the flow of funds to Parma A.C., Parmatour, and Tanzi's personal accounts.⁴⁷

While Tanzi and Tonna could hide Parmalat's true financial status by cooking its books, they still needed money (that was not coming from operations) to pay the interest on the company's loans. Thus, Parmalat repeatedly sought funds from the market in an attempt to pay its interest obligations and to refinance its expiring debt. In April 2002, Parmalat issued a €306 million convertible bond, which caused its stock price to fall.⁴⁸ Market participants started wondering why Parmalat was borrowing so much at such high rates (6% in this case), when its books showed €1.4 billion in cash.⁴⁹ Further suspicions arose in February 2003, when rumors spread that Parmalat intended to issue another €300 million bond.⁵⁰ Following another negative stock market reaction, C.O.N.S.O.B. quietly increased its surveillance of Parmalat.⁵¹ At the same time, the institutional investors with stakes in Parmalat lamented the poor quality of management's disclosures and the resulting decline in the company's stock price.⁵²

Tanzi and Tonna did not appreciate the negative publicity surrounding the announcement of a new bond offering, so they decided to obtain the funds through a series of private

⁴⁶ See *infra* Part III for a more detailed discussion. Bonlat was later replaced in part by an investment fund called "Epicurum," another cover up for Tanzi's and Tonna's fraudulent schemes. CAPOLINO ET AL., *supra* note 16, at 187.

⁴⁷ CAPOLINO ET AL., *supra* note 16, at 117-24. The authors thoroughly explain the transactions involving Bonlat.

⁴⁸ *Id.* at 131.

⁴⁹ See PARMALAT FINANZIARIA S.P.A., CONSOLIDATED FINANCIAL STATEMENTS AS OF JUNE 30, 2002 14 (2002), available at http://www.parmalat.net/en/doc/eb13_3.pdf.

⁵⁰ CAPOLINO ET AL., *supra* note 16, at 148.

⁵¹ *Id.* C.O.N.S.O.B. is the controlling authority for capital markets and listed firms in Italy.

⁵² *Id.* at 149.

placements instead. Meanwhile, in April 2003, CFO Tonna resigned, and Parmalat hired Alberto Ferraris, a former Citigroup employee and Parmalat Board member, as the new CFO.⁵³ Ferraris contacted various major investment banks, ultimately procuring the services of BoA and Deutsche Bank. In June of 2003, Morgan Stanley also helped Parmalat issue a €300 million private placement cum warrant to "Nextra Investment Management SGR," the fund management arm of Italy's Banca Intesa S.p.A.,⁵⁴ and in July, UBS underwrote a bond offering of €420 million.⁵⁵

Unfortunately for Parmalat, the investment banks' help did not solve its troubles. As Deutsche Bank announced a new €350 million private placement on September 15, 2003, Standard & Poor's ("S&P") lowered Parmalat's credit outlook from "positive" to "stable," yet left Parmalat's debt rating at

⁵³ *Id.* at 147 (arguing that Tonna did not actually stop working for Parmalat).

⁵⁴ *Id.* at 145-76. The Nextra deal is particularly interesting since, just a few months later in September 2003, Parmalat was forced to repurchase from Nextra the bonds it had just issued. It is unclear exactly why Parmalat did so, especially considering it was so short on cash. Alberto Ferraris, who became Parmalat's CEO in April of 2003, stated in an interrogatory response that when news of a new private placement underwritten by Deutsche Bank came out, Nextra, which was worried about the value of the bond it had just purchased, threatened to sell the Parmalat bond cum warrant in small denominations. Ferraris claimed that such a sale would have depressed the price of the other Parmalat bonds issued to the market without warrants. To avoid the uproar of bondholders, Parmalat was thus forced to repurchase the bond from Nextra. On the other hand, according to Enrico Bondi, who sued Nextra in connection with the Nextra deal, Nextra's bankers knew the real financial condition of Parmalat. Nextra perceived the new Deutsche Bank offering as a problem for Parmalat's stability, and it allegedly threatened Parmalat with disclosure of Parmalat's financial problems unless Parmalat repurchased the bond it had just issued. On October 6, 2004, Nextra settled out of court for €160 million. Banca Intesa claimed that it did so to avoid protracted litigation and defended its dealings with Parmalat by claiming that they were "absolutely correct." *Parmalat: The Gloves Come Off*, *ECONOMIST*, Oct. 16, 2004, at 39, 39, available at http://www.economist.com/displayStory.cfm?story_id=3292924.

⁵⁵ CAPOLINO ET AL., *supra* note 16, at 161.

BBB- (just one notch above “junk” status).⁵⁶ In mid-November, S&P began questioning Parmalat more vigorously regarding its balances. In particular, S&P became concerned about the company’s liquid assets that were invested in the Epicurum fund.⁵⁷

Thus, Parmalat’s problems began to compound. As its management team tried to convince S&P of the financial health of the company, it desperately attempted to raise the funds needed to pay off a €150 million bond expiring on December 15, 2003. But, on December 9, S&P finally lowered Parmalat’s long-term debt rating from BBB- to B+, the “junk” rating it deserved all along.⁵⁸ The fraud was not yet apparent, but Parmalat’s troubles were beginning to surface. After announcing that Parmalat had encountered problems in liquidating the Epicurum account (because the liquidity invested in it was fictitious), Tanzi officially resigned as CEO on December 14, and Enrico Bondi replaced him.⁵⁹ Bondi did not realize the true financial status of the company at that time.

⁵⁶ CAPOLINO ET AL., *supra* note 16, at 168. Italian authorities are investigating Deutsche Bank’s investment in Parmalat in the few months before the scandal erupted. Apparently, in November 2003, Deutsche Bank officially purchased 5% of Parmalat from private investors. At the same time, a Parmalat insider revealed in an interview that Parmalat hired Deutsche Bank to fix the financial problems of the Group (a task which had apparently been delegated to another firm). Three days before the scandal unraveled, on December 19, Deutsche Bank sold its shares of Parmalat, supposedly in accordance with a loan agreement with institutional investors in the United States. Deutsche Bank also assisted Parmalat in filing some documents with S&P for certification purposes (although Parmalat has been accused of forging Deutsche Bank’s logo on some of those documents). Based on these accounts, Deutsche Bank’s interactions with Parmalat appear suspicious. *See id.* at 169-74.

⁵⁷ *Id.* at 175.

⁵⁸ *Id.* at 175-76.

⁵⁹ Bondi later served as the special administrator of Parmalat in bankruptcy. *Id.* at 212. Calisto Tanzi was to go on trial in Milan on September 28, 2005. The judge assigned to the case refused his request for a plea bargain. *See* Eric Sylvers, *Judge in Italy Sentences 11 in Collapse of Parmalat*, N.Y. TIMES, June 29, 2005, at C6 [hereinafter Sylvers, *Sentencing*].

Acting upon a request from C.O.N.S.O.B., Grant Thornton ultimately revealed the fraud on December 19, 2003 when it asked BoA for an official confirmation of the notorious €3.9 billion account. It came as a big shock to many that the account listed on Parmalat's books did not exist. Italian authorities arrested Tanzi⁶⁰ on December 27, but only after Parmalat's long-term debt rating had been lowered to D,⁶¹ and Tonna had destroyed some of the computers that contained important information about the fraud. On December 29, Parmalat was declared insolvent.

At the end of January 2004, PwC, the accounting firm appointed by Bondi to replace Grant Thornton, tried to assess the true status of Parmalat's consolidated balances.⁶² The result was shocking. PwC reported that the Parmalat Group had €14.3 billion (approximately \$17.5 billion) in debt, almost eight times as much as the €1.82 billion (approximately \$2.23 billion) amount that it had declared on its balance sheet as of September 2003.⁶³ The assets of the company were described as "negligible," and there was a nearly complete lack of liquidity, since €3.9 billion of the putative €4.2 billion cash balance did not exist.⁶⁴ To make matters worse, the financial statements boasted an EBITDA

⁶⁰ CAPOLINO ET AL., *supra* note 16, at 221-22. Shortly after Tanzi's arrest, Tonna and Luciano Del Soldato, a former Parmalat CFO, were arrested as well. A judge in Milan sentenced them both on June 28, 2005. Of the eleven Parmalat executives who were convicted, Tonna received the harshest prison sentence: two years and six months. However, the Parmalat executives still await trial in Parma, where prosecutors are investigating more serious claims, like fraudulent bankruptcy, which carries a term of up to twenty years. See Slyvers, *supra* note 59, at C6.

⁶¹ CAPOLINO ET AL., *supra* note 16, at 176.

⁶² Richard Y. Roberts et al., *Spilt Milk: Parmalat and Sarbanes-Oxley Internal Controls Reporting*, SJ077 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 399, 408 (2004).

⁶³ *Id.* For Parmalat's financial statements for the third quarter of 2003, see DIRECTOR'S THIRD QUARTER 2003 REPORT, *supra* note 5.

⁶⁴ Galloni, *supra* note 10, at A3.

figure that was more than five times its actual size.⁶⁵ Furthermore, during the first nine months of 2003, Parmalat had suffered a pre-tax loss of €351 million, rather than the stated pre-tax profit of €384 million.⁶⁶

III. THE MEANS USED TO PERPETRATE THE SCHEME

Much uncertainty still surrounds the Parmalat scandal. Several lawsuits have been filed, both in Italy and in the United States, and it will be the task of judges to reconstruct exactly what happened and who is responsible. Nevertheless, in the absence of a final verdict (assuming that there will ever be one), it is possible to reconstruct a summary account of the way in which the Parmalat fraud was perpetrated. This analysis relies in large part on a journalistic reconstruction of the Parmalat scandal published by MF-Milano Finanza, one of Italy's most renowned financial newspapers,⁶⁷ as well as on statements made by Parmalat's top managers in connection with a class action lawsuit filed against Parmalat for securities violations in the Southern District of New York in October 2004.⁶⁸ The following account is not intended to be a comprehensive list of all of the fraudulent transactions executed throughout Parmalat's history, but only to describe the most common means employed to further the fraud. The objective here is

⁶⁵ Of the €651 million Parmalat declared, only €121 million of it was real. *Id.* Compare DIRECTOR'S THIRD QUARTER 2003 REPORT, *supra* note 5, at 5.

⁶⁶ Roberts et al., *supra* note 62, at 408-9. Compare DIRECTOR'S THIRD QUARTER 2003 REPORT, *supra* note 5, at 5.

⁶⁷ See generally CAPOLINO ET AL., *supra* note 16.

⁶⁸ See generally First Am. Consolidated Class Action Compl. for Violation of the Federal Securities Laws, *In re Parmalat Securities Litigation*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005) (No. 04-MD-1653) [hereinafter First Am. Class Action Compl.]. The class action is ongoing and has been consolidated with several other actions against Parmalat. See *In re Parmalat Securities Litigation*, 350 F. Supp. 2d 1356 (S.D.N.Y. 2004). For a brief journalistic summary of the lawsuits, see *Parmalat to Pursue Parts of Lawsuit*, N.Y. TIMES., Aug. 10, 2005, at C4.

to use the following account to understand how the fraud could be perpetrated and to compare it to the Enron debacle.

A. SPEs as "Accounting Dumps": Bonlat and the Fictitious Transactions

According to an interrogatory response by Luciano Del Soldato,⁶⁹ who became the CFO of Parmalat after Tonna and Ferraris resigned, Parmalat started adjusting its balances as early as the 1980s. To do this, it used wholly-owned offshore SPEs that it established to absorb Parmalat's losses through fictitious asset sales.⁷⁰ Del Soldato claims that by 1998, these SPEs had absorbed a total of €1.5 billion in nonexistent assets, and that, on the advice of the two (former) Grant Thornton partners who were in charge of certifying Parmalat's financial statements, Parmalat created another shell entity, Bonlat, in the Cayman Islands in 1999 to replace the former "accounting dumps."⁷¹

The testimony of several Parmalat officials indicates that the role played by Bonlat, which was created exclusively to be an "accounting dump," was simple yet very effective. Parmalat was accumulating operating losses in South America while siphoning funds to the Tanzi family, Parma A.C. and Parmatour. To hide this, Parmalat's management, allegedly with the help of its auditors and lawyers, would record fictitious sales of assets to Bonlat. The transactions would be recorded as assets for Parmalat and as liabilities

⁶⁹ See CAPOLINO ET AL., *supra* note 16, at 289-96 for the relevant parts of the December 22, 2003 interrogatory. On June 28, 2005, Luciano Del Soldato and Alberto Ferraris, two of Parmalat's former CFOs, were sentenced to prison terms of one year and ten months and one year and six months, respectively. *Caso Parmalat- 11 Condanne a Milano*, CORRIERE DELLA SERA (Milan), June 28, 2005, available at http://www.corriere.it/Primo_Piano/Cronache/2005/06_Giugno/28/parmalat.shtml.

⁷⁰ CAPOLINO ET AL., *supra* note 16, at 114-16.

⁷¹ On the basis of these accusations, the Grant Thornton partners who worked for Parmalat were arrested on December 31, 2003. See *Grant Thornton Executives Deny Parmalat Fraud*, TIMES ONLINE (London), Jan. 5, 2004, available at <http://business.timesonline.co.uk/article/0,,9065-952447,00.html>.

for Bonlat.⁷² Yet, since Bonlat's financial statements had to be included in the consolidated financial statements of the Parmalat Group, Bonlat had to show some sort of active entry to offset its debt to the parent company. So Parmalat's management started forging documents attesting to the execution of fictitious transactions between Bonlat and other entities (real or otherwise).⁷³ Parmalat considered these sham transactions, such as the sales of powdered milk to a Cuban company (described below), as assets on Bonlat's books. Bonlat's financial statements quickly became filled with such nonexistent assets. As Bondi explained, "[t]he fake entries gave origin to an overvaluation of the Group's performance, and to an undervaluation of its losses."⁷⁴

The testimony of Parmalat officials further indicates that, over time, Parmalat's approach to "cooking its books" became almost scientific. The Bonlat account allegedly had to be certified four times a year. Therefore, at the end of each quarter, Tonna and his colleagues had to modify Bonlat's books to make sure that the reported figures were satisfactory. At first, as Tonna and Gianfranco Bocchi⁷⁵ testified, it was necessary to estimate how much debt Bonlat had accumulated during the quarter. In the meantime, Del Soldato would study Parmalat Group's financial goals for the

⁷² CAPOLINO ET AL., *supra* note 16, at 117. See First Amended Class Action Complaint, *supra* note 68, at 71-80 for a more detailed, though perhaps speculative, reconstruction of these transactions.

⁷³ CAPOLINO ET AL., *supra* note 16, at 118.

⁷⁴ See First Amended Class Action Complaint, *supra* note 68, at 76-77 (quoting an unmarked passage of a report by Bondi dated June 19, 2004, and entitled "On the Causes for the Insolvency of Parmalat Finanziaria S.p.A. and its Holdings," that Bondi filed with Milanese prosecutors).

⁷⁵ Along with Claudio Pessina, Gianfranco Bocchi was one of Parmalat's internal accountants. Pessina and Bocchi were also arrested, and they have admitted to working closely on the fraud along with Tonna, Tanzi, and Del Soldato. On June 28, 2005, they entered a plea bargain for one year in prison. *Caso Parmalat-11 Condanne a Milano*, *supra* note 69. A partial transcript of Pessina's interrogatories can be found in CAPOLINO ET AL., *supra* note 16, at 314-29. Other excerpts from Pessina and Bocchi's interrogatories can be found throughout the First Amended Class Action Complaint, *supra* note 68.

ongoing quarter. Finally, on the basis of the targets indicated by Del Soldato, Parmalat's team of counterfeiters would get to work and produce false documents certifying the needed amounts of revenue.⁷⁶ According to the testimony of Tonna and other Parmalat officials, the falsification of financial documents became a routine task for Parmalat executives.

In order to make their falsifications appear credible, however, Bonlat also needed to show that it had an active bank account in which it held all of the funds that it booked pursuant to the fictitious transactions. According to Tonna, Bank of America was randomly picked as a target for the fictitious account, and through some tinkering with a scanner, a computer, and a printer, Bonlat's false Bank of America account was created.⁷⁷ By December 2003, that nonexistent account had ballooned to €3.9 billion.

A diverse range of fraudulent transactions filled Bonlat's books:

1. *Fictitious Sales of Powdered Milk to a Cuban State-Owned Importer.* As mentioned above, one of the techniques that Parmalat's management used was to reproduce a paper trail of false transactions that allowed Tonna and his colleagues to record fictitious assets flowing into Bonlat. An obvious benefit of such activities was the ability to artificially boost earnings to help meet investors' expectations. One of these imaginary transactions has become infamous for the unbelievable proportions of the supposed deal. In 1999, Bonlat recorded on its books a sale of powdered milk to a Cuban state-owned importer named Empresa Cubana Importadora De Alimentos ("Empresa"). The sale allegedly was executed through Camfield, a Singaporean shell company,⁷⁸ which had "sold" the powdered

⁷⁶ CAPOLINO ET AL., *supra* note 16, at 119-20, 223.

⁷⁷ *Id.* at 118.

⁷⁸ Unbeknownst to him, on the books, Camfield's CEO was Angelo Ugolotti. Mr. Ugolotti was the switchboard operator of Parmalat's offices in Collecchio. While in the process of creating Camfield, Tonna had used Mr. Ugolotti's name to avoid using his own name, thus disguising the formal tie between Camfield and Parmalat. See Brandon Mitchener,

milk to Bonlat (officially a financing company, not an operating company), which then supposedly shipped it from Singapore (of all places) to Empresa, in Cuba. Most interestingly, the alleged sale was for 300,000 tons of powdered milk at a price of \$620 million.⁷⁹ As Tonna himself recognized, had Empresa actually purchased such a quantity of powdered milk, every person in Cuba would have been able to swim in 60 gallons of milk.⁸⁰

2. *Fictitious Sales of Trademarks and Technologies.* Another scam involved the sale of fictitious trademarks or technologies to empty shells incorporated in fiscal havens. Although the assets sold did not exist or were nearly worthless, the prices recorded were extremely high.⁸¹

3. *Forged Promissory Notes.* Just as other financial documents were forged, false promissory notes were simply created at the discretion of Parmalat's executives. The goal was to ensure that the final figures shown on the books looked satisfactory to Parmalat officials.⁸²

4. *False Discounts in the Price of Goods and Services Purchased.* For many years, the Swedish company TetraPak repeatedly provided goods and services to Parmalat. Given the solid business relationship between the two firms, TetraPak would routinely grant Parmalat a discount on the price of the services it provided. It is alleged that Tanzi took advantage of this custom in two ways. First, when the discounts were actually granted, Parmalat would often record the full price as paid, while the total amount of the discount was deposited into Tanzi's personal accounts.⁸³ In contrast, when the discounts were not granted, Parmalat

Parmalat and Ice Cream Don't Go Together, Not for Mr. Ugolotti, WALL ST. J., Jan. 26, 2004, at C3.

⁷⁹ See First Amended Class Action Complaint, *supra* note 68, at 82-86. Interestingly, while the complaint states that PwC estimated the transaction to be worth \$620 million, Gumbel valued the transaction at \$1.3 billion. Gumbel, *supra* note 41, at A2.

⁸⁰ CAPOLINO ET AL., *supra* note 16, at 224-25.

⁸¹ *Id.* at 119.

⁸² *Id.*

⁸³ *Id.* at 227.

would record a lower price as an expense, thus “boosting” net income.⁸⁴

5. *The End Result.* When Bonlat was created, it inherited \$1.5 billion in worthless assets from the preceding “accounting dumps.” According to the SEC, by the end of 2001 the account had grown to \$2 billion, and by the end of 2002, Bonlat boasted \$7 billion in worthless assets. When the fraud was uncovered at the end of 2003, the unsubstantiated assets had a book value of €8.6 billion (approximately \$10.5 billion).⁸⁵

B. The Epicurum Limited Investment Fund

One of Bonlat’s functions was to cover up the diversions of funds to Parmatour⁸⁶ and Tanzi’s personal accounts. Tonna testified that in 2002, he and his colleagues realized that the size of the Bonlat account was getting out of hand and that a new strategy would be necessary to divert funds. According to Tonna’s testimony, Bianchi, Grant Thornton’s lead partner on the Parmalat audit, and Zini, the head partner of the law firm hired by Parmalat, helped to create the Epicurum Fund.⁸⁷ Epicurum, based in the Cayman Islands and allegedly run from the New York office of Zini’s law firm, had no real activities or assets.⁸⁸ Its function, as Del Soldato testified to Italian authorities, was “to create the appearance of financial activities and to conceal the misappropriation of funds by the Tanzi family.”⁸⁹ In practice, Parmalat’s participation in the fund was obtained by “selling” to Epicurum €500 million in Bonlat’s credits from Parmatour,

⁸⁴ *Id.* at 238.

⁸⁵ SEC First Amended Complaint, *supra* note 44, at 5.

⁸⁶ As explained *supra* note 35, for the sake of simplicity, I use the name “Parmatour” to refer to all the firms owned by Tanzi in the tourism sector.

⁸⁷ CAPOLINO ET AL., *supra* note 16, at 187.

⁸⁸ *Id.* at 188. On June 28, 2005, a judge in Milan sentenced Gian Paolo Zini to two years’ imprisonment. Sylvers, *Sentencing*, *supra* note 59, at C6.

⁸⁹ First Amended Class Action Complaint, *supra* note 68, at 116. See also CAPOLINO ET AL., *supra* note 16, at 188.

which means that Parmalat's liquidity in Epicurum was essentially fictitious.⁹⁰

Eventually, Epicurum played a key role in helping authorities discover the fraud. On October 31, 2003, Deloitte Touche Tohmatsu ("Deloitte"), which had replaced Grant Thornton as auditor for part of the Parmalat Group, announced that it had failed to certify Parmalat's financial statements due to the lack of information regarding Parmalat's account with Epicurum.⁹¹ After Deloitte's announcement, C.O.N.S.O.B. required Parmalat to make disclosures regarding its account with Epicurum, causing Parmalat's stock price to decline by eight percent.⁹² On November 12, Parmalat announced that it would liquidate its position in Epicurum.⁹³ On December 8, however, Parmalat was forced to announce that it had failed to liquidate its position (since it was fictitious), which led to Tanzi's resignation and the nomination of current receiver Enrico Bondi as CEO.⁹⁴

C. Fictitious Bond Repurchases

Both the SEC's complaint and the class action complaint accuse Parmalat of improperly reporting that it had purchased and retired \$3.39 billion of its outstanding debt.⁹⁵ According to Bondi, by falsifying bank documents, Bonlat was able to record the repurchase of \$3.39 billion in debt

⁹⁰ See CAPOLINO ET AL., *supra* note 16, at 188.

⁹¹ *Id.* at 179.

⁹² *Id.* at 180, 181.

⁹³ *Id.* at 185. See also Press Release, Parmalat Finanziaria S.p.A., Announcement of Liquidation of Investment in Epicurum Fund and Early Termination of Currency Swap Contract Entered Into with the Same Fund (Nov. 27, 2003), available at <http://www.parmalat.net/en/doc/2003.11.27%20Liquidation%20Epicurum%20en.pdf>.

⁹⁴ Press Release, Parmalat Finanziaria S.p.A., Statement in Relation to the Liquidation of the Epicurum Fund (Dec. 8, 2003), available at <http://www.parmalat.net/en/doc/2003.12.08%20en.pdf>.

⁹⁵ First Amended Class Action Complaint, *supra* note 68, at 104; SEC First Amended Complaint, *supra* note 44, at 6.

issued by one of Parmalat's subsidiaries.⁹⁶ Since in reality the debt remained outstanding, the result was that Parmalat's consolidated financial statements underestimated bank debt by \$3.39 billion.⁹⁷

D. Buconero ("Black Hole")

Several major international banks have been accused of playing a key role in helping Parmalat hide its true financial status. One of the transactions under examination was executed by Parmalat and Citigroup and was (ironically) baptized "Buconero" (in Italian, "buco nero" means "black hole"). According to allegations, Citigroup approached Parmalat to propose a structured financing transaction, which they ultimately executed on December 9, 2002.⁹⁸ Pursuant to the transaction, a unit of Citigroup set up a Delaware subsidiary called Buconero LLC ("Buconero"), which was meant to serve as a special financing vehicle for Parmalat, but was to remain under the control of Citigroup.⁹⁹ At the same time, Buconero entered into a joint venture agreement with the Swiss branch of Geslat Srl, a consolidated Parmalat subsidiary. According to a Parmalat press release, Buconero contributed €117 million to the partnership with Geslat.¹⁰⁰ Geslat intended to use those funds to make intercompany loans to other entities in the Parmalat Group. Pursuant to the partnership, Buconero would receive a share of Geslat's net profits.¹⁰¹

According to Bondi, Parmalat designed Buconero to help portray the loan as an equity investment on its balance sheet.¹⁰² Allegedly, since Geslat was officially receiving funds

⁹⁶ See First Amended Class Action Complaint, *supra* note 68, at 104.

⁹⁷ See *id.*

⁹⁸ See CAPOLINO ET AL., *supra* note 16, at 200.

⁹⁹ Reilly & Galloni, *supra* note 42, at A1.

¹⁰⁰ Press Release, Parmalat Finanziaria S.p.A., Parmalat Finanziaria Details of Participation Agreement (Nov. 21, 2003), available at <http://www.parmalat.net/en/doc/2003.11.21%20Geslat%20en.pdf>.

¹⁰¹ *Id.*

¹⁰² See Reilly & Galloni, *supra* note 42, at A1.

from a partner, Parmalat recorded the amounts contributed by Buconero as equity. In reality, Citibank structured the transaction to give the bank a bond-like rate of return, while effectively shielding it from a loss on the investment.¹⁰³ Therefore, forensic accountant Stefania Chiaruttini, working with Italian prosecutors, argues that the amounts received should have been recorded as debt.¹⁰⁴ According to these accusations, the net effect of the Buconero deal was to overstate Parmalat's equity and to understate its debt.

E. Double Billing

Parmalat did not merely create wholly fictitious transactions. Allegedly, Parmalat also made extensive use of a "double billing" scheme to overstate its assets and obtain liquidity.¹⁰⁵ Some court documents, prepared a few months after the fraud was discovered, estimate that the exploitation of double invoices might have helped Parmalat collect about €4 billion in loans alone.¹⁰⁶

According to accusations backed by the testimony of some insiders, Parmalat issued duplicate invoices to distributors, franchisees and hundreds of supermarkets in Italy.¹⁰⁷ These duplicate invoices allowed Parmalat to book fictitious sales to obtain liquidity, in the form of credit, from banks.¹⁰⁸ Additionally, Parmalat has been accused of exploiting the securitization of false invoices. According to accusations, with the help of Citigroup's Eureka Securitization Inc., Parmalat devised a securitization program for phony receivables that allowed Parmalat to collect hundreds of millions of euros.¹⁰⁹

¹⁰³ *Id.*

¹⁰⁴ First Amended Class Action Complaint, *supra* note 68, at 90.

¹⁰⁵ See *Parmalat Simply Sent Its Invoices Out Twice*, SYDNEY MORNING HERALD, Feb. 3, 2004, available at <http://www.smh.com.au/articles/2004/02/02/1075570362802.html>.

¹⁰⁶ *Id.*

¹⁰⁷ First Amended Class Action Complaint, *supra* note 68, at 91.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 91-96.

Although the extent of Parmalat's use of double billing and the securitization of false receivables is yet to be determined, the clear effect of such schemes was to overstate Parmalat's cash flow from operations, its revenues, its net income, and its assets, hence concealing the true financial status of the Group.

F. Reclassification of Debt as Intercompany Debt

Parmalat has also been accused of reclassifying part of its outstanding debt as intercompany debt. There is still a great deal of uncertainty regarding the nature and the extent to which Parmalat availed itself of this particular scheme. For example, the SEC complaint alleges that Parmalat mischaracterized "€300 million (\$348 million) of bank debt as intercompany debt."¹¹⁰ On the other hand, the class action complaint goes much further, arguing that Parmalat made "adjustments to reclassify \$4.49 billion in debts to banks as inter-company debts."¹¹¹ Although there is obvious disagreement as to the magnitude of the scheme, in essence, it is alleged that when consolidating the company's financial statements, Parmalat officials would simply reclassify part of the debt owed to third parties as intercompany debt. Since intercompany loans do not appear on consolidated financial statements, the net effect was to understate Parmalat's debt.¹¹²

G. Various Other Techniques

According to prosecutors, plaintiffs, and the testimony of some Parmalat officials, Parmalat used several other illegal techniques to alter the financial statements of the Group. Some of these include: the exploitation of stale invoices in factoring schemes;¹¹³ the fabrication of financial transactions

¹¹⁰ SEC First Amended Complaint, *supra* note 44, at 6.

¹¹¹ First Amended Class Action Complaint, *supra* note 68, at 101.

¹¹² SEC First Amended Complaint, *supra* note 44, at 6. *See also* First Amended Class Action Complaint, *supra* note 68, at 101.

¹¹³ First Amended Class Action Complaint, *supra* note 68, at 96.

(for example, interest rate swaps) intended to offset losses;¹¹⁴ the improper amortization of goodwill;¹¹⁵ and the inappropriate removal of liabilities from Parmalat's books.¹¹⁶

H. Where Did the Money Go?

When the fraud was discovered, PwC estimated that Parmalat had accumulated a debt mountain of €14.2 billion.¹¹⁷ Although the details are still unclear, Enrico Bondi estimated that Parmalat spent the money as follows:

Table 1. Estimated Use of Parmalat's Debt Proceeds¹¹⁸

| Use | Amount (€ billions) |
|---|------------------------|
| Acquisitions | 3.8 |
| Interest payments and fees related to bank debt | 2.8 |
| Interest payments and fees related to bonds | 2.5 |
| Funds siphoned off from the company | 2.3 |
| Losses at operating units | 1.6 |
| Taxes | 0.9 |
| Dividends | 0.3 |
| TOTAL | 14.2 |

At the moment, it is hard to piece together a coherent account of exactly how Parmalat perpetrated the fraud. Different sources disagree as to the nature of the transactions, their size, and the responsibilities of the parties involved. Although some of the parties who were

¹¹⁴ SEC First Amended Complaint, *supra* note 44, at 4. See also CAPOLINO ET AL., *supra* note 16, at 225.

¹¹⁵ First Amended Class Action Complaint, *supra* note 68, at 120.

¹¹⁶ *Id.* at 122. See also SEC First Amended Complaint, *supra* note 44, at 6.

¹¹⁷ See Galloni & Reilly, *supra* note 43, at C1.

¹¹⁸ See *id.*

directly involved in the fraud have admitted to playing a role and have accused others of doing so as well, their testimony must be viewed with some caution. It is up to the courts on both continents to reconstruct the events and assign guilt. The goal of this Note is simply to begin to unravel the Parmalat debacle and to attempt to draw some conclusions about the corporate failures that precipitated it.

IV. IS PARMALAT EUROPE'S ENRON?

There are two possible ways of interpreting the question, "is Parmalat Europe's Enron?" The first is to ask whether the Parmalat scandal can be considered the European mirror image of the Enron scandal: a scandal with similar causes, perpetrated by similar techniques, which just happened to develop in a different location. The answer to this question appears to be "no," since the Parmalat scandal does differ from the Enron debacle in various substantial respects. The second approach is to ask whether Parmalat can be seen as a variation on the Enron scandal, substantively affected by some European (or at least Italian) factors. Insofar as Parmalat demonstrates the blatant failure of the financial gatekeepers to deter or detect a series of fraudulent acts, this scandal does resemble the Enron scandal. But, the specific contours of the fraud have been greatly influenced by its European setting, giving the scandal a markedly European flavor. In this sense, the answer to the second question would be "yes."

The purpose of this section is to try to answer four basic questions regarding the Parmalat scandal: "Who was involved?"; "Why?"; "How did they do it?"; and "Whose fault is it?"

This Note will then compare the answers to each of these questions to the answers to these same questions concerning Enron. The objective of this analysis is to argue that Parmalat differs from Enron in some basic aspects, but that the two scandals do bear important similarities (most strikingly, the failure of gatekeepers) from which we can draw certain lessons in corporate governance. Given the scope of both scandals, it would be impossible to analyze in

depth all of the failures in corporate governance present in either fraud in a single paper. Therefore, the objective of this Note is to provide an overview of the similarities and differences between the failures in corporate governance that gave rise to each of the scandals. The hope is that this Note will serve as a starting point for future endeavors to analyze the issues summarily covered herein.

A. Who Was Involved?

At the time news of their scandals broke, Parmalat and Enron were two very different companies. Enron was one of the largest companies in the world, with a broad range of operations that originally focused on the production and supply of gas. In the 1990s, under the leadership of Jeff Skilling, Enron developed a new trading model that effectively turned the company into a "gas bank."¹¹⁹ Acting as an intermediary between suppliers and buyers of natural gas, Enron eventually exported its business model to different markets (such as electric power, water, and broadband cable) and countries around the world.¹²⁰ By 2001, Enron boasted \$100 billion in revenues and almost \$1 billion in profits.¹²¹ Its complex operations required extensive use of sophisticated structured finance transactions.¹²² In comparison, Parmalat was an old-line food company with revenues less than one-tenth the size of Enron's.¹²³

¹¹⁹ Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, 17 J. ECON. PERSP. 3, 6 (2003).

¹²⁰ *Id.* at 8.

¹²¹ ENRON, 2000 ANNUAL REPORT 1 (2001), available at <http://www.enron.com/corp/investors/annuals/2000/ar2000.pdf>.

¹²² Healy & Palepu, *supra* note 119, at 9.

¹²³ See DIRECTOR'S THIRD QUARTER REPORT, *supra* note 5, at 5. Note that some authors have argued that Enron's revenues were actually much smaller. After revising Enron's financial statements using much more conservative accounting standards, Dharan and Bufkins calculate Enron's revenues at \$6.3 billion, approximately the size of Parmalat's real (not declared) revenues. BALA G. DHARAN & WILLIAM R. BUFKINS, RED FLAGS IN ENRON'S REPORTING OF REVENUES AND KEY FINANCIAL MEASURES, IN ENRON:

Albeit on different scales, both companies displayed rather quick and impressive growth. From 1996 to 2000, Enron's revenues increased by more than 750%, from \$13.3 billion to \$100.8 billion.¹²⁴ In 1996, Parmalat declared €2.8 billion in revenues,¹²⁵ which by 2003 had increased to €7.7 billion, a 275% increase.¹²⁶ As they grew, both companies diversified their businesses and exported their operations around the globe.

However, the nature of their expansions differed in two respects. First, while Parmalat's revenue growth was mostly driven by a bold sequence of acquisitions, Enron's growth was a result of its success in the market, and the use of some aggressive revenue recognition accounting techniques.¹²⁷ Enron's growth was arguably facilitated by a large market bubble, which made it easier for the company's management to push GAAP accounting to its limits without really worrying their accountants and the regulators.¹²⁸ Second, the growth of the two companies was motivated by two different needs: while Parmalat needed to grow to be able to hide the magnitude of its debt and its financial problems,¹²⁹

CORPORATE FIASCOS AND THEIR IMPLICATIONS 97, 103 (Nancy B. Rapaport & Bala G. Dharan eds., 2004).

¹²⁴ DHARAN & BUFKINS, *supra* note 123, at 99.

¹²⁵ PARMALAT FINANZIARIA S.P.A., 1998 ANNUAL REPORT 9 (1999), available at http://www.parmalat.net/en/doc/e_bill1.pdf. The 1998 Report measures revenues in Italian Lire. The €2.8 billion figure is obtained by multiplying the figure in Italian Lire by the Euro exchange rate as of December 9, 2003 (0.00051650 Lire per Euro). See <http://www.oanda.com/convert/fxhistory>.

¹²⁶ PwC calculated that Parmalat overstated its 2002 revenues by approximately €1.5 billion. CAPOLINO ET AL., *supra* note 16, at 67. Assuming the 1996 figure is correct, according to PwC's reconstruction of the events, the actual growth rate of the Group from 1996 to 2003 was 185%.

¹²⁷ DHARAN & BUFKINS, *supra* note 123, at 101.

¹²⁸ For a discussion of the way in which accounting principles might have played a role in the inflation of the market bubble and the Enron scandal, see Stephen H. Penman, *The Quality of Financial Statements: Perspectives From the Recent Stock Market Bubble*, 17 ACCT. HORIZONS, Supplement 2003, at 77.

¹²⁹ See SEC First Amended Complaint, *supra* note 44, at 5.

Enron's management boosted earnings in pursuit of personal economic gains (although Enron did cover up some losses by growing).¹³⁰

Another key difference between the two companies is the duration of the fraud. In the Enron case, some aspects of the fraud were initiated in 1997 and the fraud was uncovered by 2001.¹³¹ By contrast, the Parmalat fraud lasted for a much longer period of time. Although it is not yet clear when the systematic adjustments to Parmalat's financial statements began, there is some evidence that the fraud might have been initiated approximately fifteen years before it was discovered, around the time that Parmalat went public in 1989.¹³² A question naturally arises: How could have it gone undetected for so long? A definitive answer has yet to be given, but the conclusion of this Note offers a speculative answer.

Finally, the most relevant difference between Parmalat and Enron relates to their ownership structures. Parmalat, with its confusing corporate structure made up of layers of holding companies and subsidiaries, has always been majority-owned and controlled by its founder, Calisto Tanzi.¹³³ In June 2003, a few months before the fraud was discovered, Tanzi owned 51.3% of Parmalat through Coloniale S.p.A., the holding company of the Parmalat Group. Two institutional investors owned approximately 2.1% each (they were Lansdowne Partners Limited Partnership and Hermes Focus Asset Management Europe Limited), while the public owned the remaining 44.5% of the company's equity.¹³⁴ On the other hand, Enron was not

¹³⁰ DHARAN & BUFKINS, *supra* note 123, at 101.

¹³¹ See George J. Benston & Al L. Hartgraves, *Enron: What Happened and What We Can Learn from It*, 21 J. ACCT. & PUB. POL'Y 105, 105 (2002).

¹³² Marco Onado, *Un'autentica truffa all'italiana*, EUROZINE, Mar. 10, 2004, available at <http://www.eurozine.com/pdf/2004-03-10-onado-it.pdf>.

¹³³ *Got Milked?*, *supra* note 6, at A12.

¹³⁴ See Commissione Nazionale per Le Società e la Borsa, 30/06/2003, Parmalat Finanziaria SPA - Ownership, http://www.consob.it/main/en/issuers/listed_companies/query_infostoriche.html?queryid=main.emittenti.societa_quotate.form_avanzato&codconsob=5566&resultmethod=socquota

controlled by a majority shareholder. At the end of 2000, several large institutional investors owned 60% of its stock, but none of them had enough power to control the company.¹³⁵ The remaining 40% ownership interest was widely dispersed.

The difference in the corporate ownership structures of Enron and Parmalat led to two different conflicts of interest. Enron's ownership structure gave rise to an agency problem between shareholders and management. With dispersed ownership, individual shareholders are incapable of effectively monitoring the behavior of management. Without an incentive to act in the best interest of shareholders, management is less likely to act in ways that maximize shareholder value. In the U.S., a common approach to reducing these conflicts of interest is to tie management compensation to the firm's stock price performance through option awards. Accordingly, in 2001, Enron awarded Kenneth Lay, Jeff Skilling, and other officers and directors a large number of stock options.¹³⁶

These generous stock option awards certainly gave Enron's management an incentive to maximize share value. But share value can be maximized either by increasing the fundamental value of the company through appropriate business decisions or simply by giving the market the false impression that the firm's performance has improved. Companies can overinflate firm performance by boosting the company's total revenue figures.¹³⁷ Such measures allow management to avoid acting in the best interests of shareholders, as self-interested transactions that hurt shareholders can be covered up by "cooking the books." This is exactly what Enron's management did (at least until the fraud was discovered). In less than one year, Enron's stock

dv&search=1 (click on "Voting Capital pie chart") (last visited Nov. 12, 2005).

¹³⁵ Healy & Palepu, *supra* note 119, at 16.

¹³⁶ *Id.* at 13.

¹³⁷ DHARAN & BUFKINS, *supra* note 123, at 100.

price fell from \$83.13 on December 31, 2000, to \$0.26 on December 2, 2001, after the fraud was discovered.¹³⁸

The conflicts of interest present in Parmalat were different. As mentioned above, Parmalat was always controlled by its founder, Calisto Tanzi. Tanzi was not only the controlling owner, but he was also the chairman and the CEO.¹³⁹ This dramatic concentration of powers led to an obvious conflict of interest: Tanzi had an incentive to exploit his position to take personal advantage of the resources of the company, at the expense of minority shareholders and creditors. One of the accusations against Tanzi is indeed that he transferred hundreds of millions of euros of the company's funds to his personal and family accounts.¹⁴⁰ As it is argued in the next subsection, the Parmalat fraud was also partly motivated by the desire to keep the company from going bankrupt.

The distinct conflicts of interest present in the Enron and Parmalat scandals resulted in fundamentally different fraud schemes: in the first, management sought to inflate earnings to maximize share price, whereas in the second, the controlling owner endeavored to hide the diversion of assets into his personal accounts from minority shareholders and creditors.¹⁴¹ The common denominator of both the Enron and the Parmalat scandals is that without the acquiescence of gatekeepers, such as auditors and internal controls, the frauds could never have occurred.¹⁴²

B. Why?

As described in the previous subsection, the Parmalat and Enron frauds originated in different settings. Nevertheless, it might seem natural to argue that in both cases, greed was the driving force. However, by looking closely at the two scenarios, it is possible to distinguish between the

¹³⁸ Healy & Palepu, *supra* note 119, at 3, 12.

¹³⁹ DIRECTOR'S THIRD QUARTER 2003 REPORT, *supra* note 5, at 3.

¹⁴⁰ Galloni, *supra* note 10, at A3.

¹⁴¹ Coffee, *supra* note 13, at 333.

¹⁴² *Id.*

motivations behind the actions of the managers at Enron and Parmalat. Enron's scheme was ultimately devised with the goals of: "(1) making Enron appear more financially successful than it actually was, (2) artificially inflating Enron's stock price, (3) avoiding government regulations both to gain undeserved benefits and to avoid legally proper costs, and (4) obtaining personal enrichment."¹⁴³ Enron's managers understood that had they released the true earnings of the company, they would have lost considerable wealth in the form of their stock options as disappointed investors drove the stock price down. They also feared the potential lawsuits accompanying poor performance and the loss of their management positions.¹⁴⁴ At its core, Enron's management designed the fraud scheme to perpetuate their positions while undeservedly reaping substantial economic benefits. For example, Enron announced that Fastow alone earned more than thirty million dollars from the partnerships that management used to hide Enron's financial problems.¹⁴⁵ Hence, it can be argued that the Enron scandal was mostly driven by management's greed.

Another common reason for cooking the books is that managers are trying to "weather out the storm."¹⁴⁶ In the optimistic hope that the business will eventually recover, managers temporarily alter the company's financial statements either to avoid bankruptcy or to continue operations with adequate funding and customer/supplier support, or both.¹⁴⁷ The Parmalat case displays aspects of both Enron-style greed and "weather it out" motivations. It is undeniable that greed played a key role in shaping the

¹⁴³ George W. Kuney, *Everything I Needed to Know About Enron I Learned in Kindergarten (and Graduate School)*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 877, 879 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

¹⁴⁴ Baruch Lev, *Corporate Earnings: Facts and Fiction*, J. ECON. PERSP. 27, 29 (2003).

¹⁴⁵ Wendy Zellner et al., *The Fall of Enron*, BUS. WK., Dec. 17, 2001, at 30.

¹⁴⁶ See Kuney, *supra* note 143, at 29.

¹⁴⁷ *Id.*

behavior of all the players involved in the Parmalat fraud, as most of them personally benefited from it. For example, Tonna has admitted to deriving personal gains from the execution of Tanzi's plans.¹⁴⁸ Others, such as the lawyer Zini and Luca Sala, a former Bank of America employee who allegedly helped Parmalat execute some of its fraudulent transactions, are accused of receiving substantial amounts of money for their services.¹⁴⁹ As explained earlier, Tanzi is also accused of diverting hundreds of millions of euros from Parmalat to his personal accounts or to those of other companies owned by his family. According to some reconstructions of the scandal, Tanzi siphoned off a total of \$2.82 billion from Parmalat.¹⁵⁰ While it is unclear where most of this money went, significant amounts were undoubtedly used to help the struggling Parmatour and other family enterprises.¹⁵¹

Still, the central motivation behind the Parmalat fraud was to try to keep the company afloat. Unlike Enron, which in 1997 may not have been in the best shape but was far from bankrupt, allegedly Parmalat was technically insolvent from the year it went public.¹⁵² And when things became dramatically worse in 1998, due mostly to the South American crisis, Tanzi decided to use scams such as the Bonlat "accounting dump" to avoid shutting Parmalat down.¹⁵³ In fact, Tonna testified that Bonlat was conceived by Tanzi as a temporary remedy that they could couple with

¹⁴⁸ *Parma Splat*, *ECONOMIST*, Jan. 17, 2004, at 13.

¹⁴⁹ For example, Sala allegedly misappropriated approximately \$27 million from Parmalat in connection with some of the work he did for the company at Bank of America. See Reilly & Galloni, *Spilling Over*, *supra* note 42, at A1. Sala was arrested on August 3, 2005 and is currently under investigation. *Ex-US Bank Employee Arrested*, *WALL ST. J.*, Aug. 3, 2005, at C4.

¹⁵⁰ Galloni & Reilly, *Parmalat Spent*, *supra* note 43, at C1.

¹⁵¹ See *id.*; Galloni & Trofimov, *supra* note 14; Alessandra Galloni, *Parmalat Executive Tries Out New Role: Playing Mr. Nice Guy*, *WALL ST. J.*, Dec. 27, 2004, at A1 [hereinafter Galloni, *Mr. Nice Guy*].

¹⁵² See Biondani & Fumagalli, *supra* note 22, at 5.

¹⁵³ *Id.* at 109-11.

a search for a more permanent solution to the financial problems of the Group.¹⁵⁴

Two considerations strengthen the argument that Parmalat's fraud was conceived to "weather out" the operational problems of the company. First, unlike Enron, Parmalat had been founded by Tanzi himself, and it had always been under the control of the Tanzi family. The personal attachment to a firm that he had created and nurtured for over forty years can explain Tanzi's reluctance to let it go bankrupt. Second, the motivations of Parmalat's and Enron's management differ in their social dimension. Parmalat's headquarters had always been located in the small town of Collecchio, which has less than 12,000 inhabitants.¹⁵⁵ Parma, the "metropolis" in which Tanzi conducted most of the company's business, currently counts less than 160,000 inhabitants.¹⁵⁶ In such a small social scene, the impressive growth of Parmalat brought Tanzi a great deal of recognition. Soon his name was known all over Italy. Upon purchasing the soccer team Parma A.C., he officially became one of Italy's most respected and admired "celebrities." And with money came power. Thanks to his economic success, Tanzi was able to acquire the friendship and protection of various politicians.

However, it would be foolish to argue that Enron's management was immune from the influence of the company's success and the political attention it drew. For years, Enron maintained strong ties with Washington by contributing generously to both the Democratic and the Republican parties.¹⁵⁷ It is not a mere coincidence that George W. Bush would affectionately call Kenneth Lay "Kenny Boy" (at least up until the scandal unraveled, when

¹⁵⁴ *Id.* at 122.

¹⁵⁵ Comune di Collecchio, <http://www.comuniitaliani.it/034/009/index.html> (last visited Nov. 6, 2005).

¹⁵⁶ Comune di Parma, <http://www.comuni-italiani.it/034/027/> (last visited Nov. 6, 2005).

¹⁵⁷ Don Van Natta, Jr., *Enron's Collapse: The Politicians*, N.Y. TIMES, Jan. 21, 2002, at A13.

"Kenny Boy" suddenly became "Mr. Lay").¹⁵⁸ Yet despite their strong political ties and the standing that they acquired within high-class circles, Enron's managers arguably never acquired the "celebrity" status that Tanzi and other top Parmalat officials achieved. So, while the risk of bankruptcy for Lay and his colleagues primarily meant the potential loss of great amounts of money, for Tanzi and his colleagues, it meant the destruction of a family-owned business and the loss of a status that they had worked hard to acquire.

The suggestion that Parmalat's fraud was in great part an attempt to "weather out the storm" ties in nicely with the considerations outlined above regarding the differences between the impressive growth stories of Enron and Parmalat. As previously mentioned, both firms displayed striking growth patterns (at least on their books). But while Enron's management wanted to boost revenues to increase the company's stock price and achieve economic benefits, Parmalat did not pursue acquisitions primarily to increase revenues for the benefit of management. Instead, Parmalat needed to grow in size to continue operations and conceal its fraud, as evidenced by Parmalat's new acquisition in South Africa a few months before the fraud unraveled.¹⁵⁹ As Vito Zancani, the chief investigating magistrate in Parma declared, "[i]t was a reversal of logic, [Parmalat] had to grow to hide the debt."¹⁶⁰ In practice, Parmalat resembled a massive Ponzi scheme, destined to collapse once its sources of cash flow drained. This evidence supports the argument that the main motivation behind the Parmalat fraud was to prevent the company from going bankrupt.

Overall, both scandals were characterized by greed. Greed was ultimately the reason why so many people acquiesced to the fraudulent schemes conceived by both

¹⁵⁸ *Id.*

¹⁵⁹ Press Release, Parmalat Finanziaria, Acquisition in South Africa, (July 23, 2003), available at <http://www.parmalat.net/en/doc/2003.07.23%20South%20Africa%20en.pdf>.

¹⁶⁰ Gumbel, *supra* note 41.

Enron's and Parmalat's managers. But the motivations behind the two frauds actually differ. Indeed, the Parmalat case was shaped by more typically European factors. First, while it is relatively uncommon for large U.S. businesses to be family-owned, this phenomenon is more widespread in Europe.¹⁶¹ The presence of a controlling owner in the Parmalat scandal meant that different conflicts of interest were present in that situation as compared to the Enron scandal. Moreover, the fact that the company was family-owned provided Tanzi with an additional motivation to keep Parmalat from going bankrupt. Second, the Parmalat fraud took place in a very European (or at least Italian) social setting; since the social and political scene in European countries is much more parochial than in the U.S., it is easier for a rich businessman to acquire a dominant social position.¹⁶² Since the success of his business is the reason behind a businessman's social status, he will be very reluctant to let the business go bankrupt.

Finally, the differences in Enron's and Parmalat's managers' motivations led to disparate "real" economic effects.¹⁶³ The evidence presented above suggests that at the time the fraud was discovered, Parmalat's financial position was much more dire than Enron's. And while greed, rather than financial problems, spurred Enron's management to falsify its financial statements, Parmalat's management was compelled by the company's disastrous financial situation to "improve" its books so that it could "weather out the storm." Accordingly, the two frauds had disparate "real" economic effects. Intuitively, it seems much worse to allow an inefficient company to stay in business through fraud than to allow the management of a relatively healthy company to

¹⁶¹ Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 471-72 (1999).

¹⁶² This is not to say that American managers do not enjoy the social benefits deriving from their business success, but arguably, given the smaller Italian industrial scene, social influence was a more prominent factor in the Parmalat scandal than in the Enron scandal.

¹⁶³ By "real economic effects," I mean the actual impact of both frauds on the allocation of economic resources in society.

steal money from shareholders. In reality, the primary effect of the Enron fraud was a massive transfer of wealth from Enron's shareholders and employees (through their pension fund holdings) to Enron's managers. The fraud was executed mainly through sophisticated financial transactions. Yet, apart from this wealth transfer (which certainly caused some inefficient allocations of capital and unjustly deprived thousands of investors of their savings), the extent of the "real" economic damage caused by the Enron fraud is unclear. On the other hand, Parmalat's fraud seems to have caused a more serious misallocation of economic resources. Parmalat had been insolvent for many years, and it was allowed to stay in business only because its management undertook fraudulent schemes to perpetuate it. To keep hiding the fraud and "weather out the storm," Parmalat decided to undertake an aggressive series of acquisitions. Consequently, Parmalat continued expanding while inefficiently managing a growing amount of debt. Therefore, while Enron's managers simply enriched themselves at the expense of shareholders, Parmalat effectively wasted substantial economic resources for over a decade.

C. How Did They Do It?

Part III above gives a general account of the fraudulent techniques that Parmalat's management team employed to disguise the true financial status of the company. On the other side of the Atlantic, much of the Enron "fraud revolve[d] around the creation and management of 'off balance sheet' partnerships," which seemed to inflate revenue and conceal debt.¹⁶⁴ Enron's managers achieved these purposes primarily by: "(1) engaging in fraudulent transactions involving special purpose entities ('SPEs'), (2) filing false and misleading financial statements with the SEC, (3) making false statements concerning the health of Enron's underlying business model, and (4) exercising

¹⁶⁴ Kuney, *supra* note 143, at 880.

control over both the main company and the 'independent' [SPEs] for personal benefit."¹⁶⁵

In comparing the preceding list of techniques used by Enron's managers with those Parmalat's managers used, it is clear that Parmalat used all of the means employed by Enron. The Bonlat "accounting dump" alone encompassed all four of the abovementioned activities. Bonlat was simply an SPE that Parmalat used illicitly to conceal the true financial status of Parmalat from authorities and investors, while at the same time helping Tanzi siphon off funds to his personal and family accounts.

Although some authors disagree about the degree of complexity of Enron's fraud,¹⁶⁶ both companies clearly made extensive use of sophisticated structured finance transactions. The key difference is that, surprisingly, Parmalat also employed more traditional means to falsify its records. One of the reasons that the SEC defined the Parmalat scandal as "brazen"¹⁶⁷ is that Parmalat's management embarked on an astonishing sequence of simple forgeries. This aspect of the Parmalat scandal can help to shed light on why, unlike in the post-Enron debate, so much of the talk about reform post-Parmalat has focused on gatekeepers rather than on accounting regulations. In fact, the Enron and Parmalat scandals differed in one significant regard: while Enron's management defrauded shareholders by pushing accounting regulations to their limits (until it eventually broke them), Parmalat's management simply created false documents, painting a picture of an imaginary company for the eyes of the public. Parmalat thus took Enron's fraud to the next level; instead of distorting its accounts, it simply forged a set of completely different ones. The fact that Parmalat was able to hide its problems by using a scanner, scissors, and glue certainly raises a

¹⁶⁵ *Id.* at 879. A more accurate account of the accounting techniques used by Enron's management is provided by Benston & Hartgraves, *supra* note 131.

¹⁶⁶ Compare Kuney, *supra* note 143, at 885 with Benston & Hartgraves, *supra* note 131, at 107.

¹⁶⁷ SEC Charges, *supra* note 7.

question as to whether complex financial and regulatory systems are equipped to detect even the most basic type of financial forgery.

On the Enron side, many critics have noted that a number of the accounting means used by Skilling and his colleagues were actually legal.¹⁶⁸ These critiques point out the way in which Enron's management had been able to exploit the flexibility of existing accounting regulations to the detriment of shareholders and creditors. Indeed, the Enron fraud relied upon accounting and structural engineering that was largely apparent to its monitors (auditors and the Board of Directors in *primis*), and even approved by them. Many of the SPEs created by Enron officials were sanctioned by GAAP (at least in form). The failure of the monitors was to some extent a failure to distinguish form from substance, which could partly be blamed on the "rules-based" GAAP regime that encourages firms to structure their affairs around "bright lines." In short, Enron was much more of an accounting scandal than Parmalat was, as exemplified by the consequent reform of the whole U.S. financial reporting and measurement system.

D. Whose Fault is It?

It is probably too early to assign blame for what occurred in the Parmalat scandal. As of September 2005, parties have filed numerous lawsuits on both sides of the Atlantic.¹⁶⁹ Nonetheless, one thing is obvious — someone outside of Parmalat's management must have participated in the fraud in a substantial manner. To perpetrate the scheme, Parmalat's managers would have needed to deceive approximately eleven sources of control, including: (1) the Board of Directors; (2) the internal Audit Committee; (3) the external auditors; (4) the lawyers; (5) the analysts; (6) rating

¹⁶⁸ See Lev, *supra* note 144, at 45. I owe the insights provided in this paragraph to Professor Stephen Penman.

¹⁶⁹ *Parmalat to Pursue Parts of Lawsuit*, N.Y. TIMES, Aug. 10, 2005, at C4, (providing a summary account of some major ongoing lawsuits as of August 2005).

agencies; (7) the banks that provided loans; (8) the banks that underwrote securities; (9) the financial press; (10) the investors; and (11) the regulatory agencies (C.O.N.S.O.B. in particular).¹⁷⁰ It is simply too difficult to believe that a fraud this large could have gone undetected for so long.

The problem in both the Parmalat and Enron scandals was ultimately the use of misleading information to defraud the market. There are two sides to the problem: (a) the supply side of the information (the Board of Directors, the internal controls, external auditors, investment bankers, and lawyers), which allegedly contributed to the production of fraudulent information, and (b) the demand side, which failed to detect the problems with the information supplied.¹⁷¹ These two sides are interdependent: the supply side responds to the needs of the demand side and provides it with accurate information, while the demand side requires useful information and correct analysis. A failure on either side is likely to compel a failure on the other side.¹⁷² Most notably, a failure on the supply side to provide accurate information increases the likelihood that the demand side will perpetuate an inaccurate assessment of reality.

In both the Enron and Parmalat cases, it is hard to assign responsibility to a single independent culprit because various players in the corporate system shared accountability. Because of the "systemicity" in the market for information, i.e., the failure of any one player in the system increases the likelihood that other players will fail as well, the blame for the Enron and Parmalat frauds must be shared between many parties.¹⁷³ For example, if auditors certify the financial statements prepared by management even though they do not comply with accepted accounting principles, rating

¹⁷⁰ MariaKatia Di Staso, *Il Caso Parmalat* 58 (Aug. 2004) (Archivio Ceradio of Libera Università Internazionale degli Studi Sociali Working Paper), available at <http://archivioceradi.luiss.it/documenti/archivioceradi/impresa/banca/parmalat.pdf>.

¹⁷¹ Cf. Lev, *supra* note 144, at 43.

¹⁷² See *id.* at 43 (analyzing the way failures of the demand and supply side affected the other side, respectively, in the Enron case).

¹⁷³ *Id.* (providing a graphic illustration of a similar concept).

agencies are more likely to accept those balances as accurate and to give the company a higher debt rating than it deserves. Accordingly, investment bankers might rely on the rating agency's opinion to lend the company money, while investors, given the company's positive rating and the willingness of investment banks to lend the firm money, might decide to buy the firm's stock.

This analysis applies equally to Enron and Parmalat. The fraud schemes created a domino effect in both cases: the supply side failed by creating misleading information, which led to the failure of the demand side players. In the Parmalat case, the supply side suffered from a principal/agent problem that allegedly led some auditors, lawyers, and bankers to participate in the production of fraudulent information. This fraudulent information caused rating agencies to assign Parmalat's debt an undeserved "investment grade" rating. Due to the systemic nature of the information market, the failure by rating agencies (and any other demand side players) led to the apparent failure of investors, analysts, and regulatory agencies. On top of that, the longer the fraud continued, the more Parmalat kept growing. As Parmalat grew, it established itself as a legitimate industrial giant, making the demand side less likely to question the legitimacy of the information produced by the company and the supply side. The biggest lie is sometimes the easiest to believe.

What follows is a summary account of how the different demand side and supply side players allegedly failed to perform their screening functions.

1. Supply Side

a. The Board of Directors and the Audit Committee

The Board of Directors and the Audit Committee of Enron had truly impressive qualifications. All of the Board's

members were highly qualified and well regarded.¹⁷⁴ The Board followed many of the best practices for good corporate governance, and it was even acclaimed as one of the best boards in corporate America.¹⁷⁵ On the other hand, Parmalat's Board of Directors and its Audit Committee were not as impressive. While the Enron Board boasted a former Dean of the Stanford Business School, Tanzi, the Chairman and CEO of Parmalat, and Tonna, the CFO, had only high school diplomas. Of Parmalat's thirteen directors, four had direct family ties to Tanzi, several had worked with him for years, and only three were officially declared to be "independent."¹⁷⁶ Parmalat's Board practices were so unprofessional that Institutional Shareholder Services, a group that promotes good corporate governance, rated it at the bottom of a list of its Italian peers in a governance survey.¹⁷⁷

Despite these stark differences, Enron's Board and Audit Committee failed as much as Parmalat's. Certainly, the failure is not surprising in Parmalat's case. After all, Tanzi was the controlling owner, the Chairman of the Board and the CEO. He had an undue influence on the Board and the Audit Committee, which were certainly not independent. The failure of Enron's Board is more surprising. Whereas Parmalat's Board and Audit Committee failures can be explained mostly by the influence exerted by Tanzi on the two bodies, Enron's failure was likely due in part to the hesitation of Enron's directors to second guess either the auditors on technical accounting questions or the validity of representations provided by management.¹⁷⁸

¹⁷⁴ Marleen A. O'Connor, *The Enron Board: the Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1236 (2003).

¹⁷⁵ *Id.* at 1237.

¹⁷⁶ Melis, *supra* note 12, at 484-85.

¹⁷⁷ *Where's All the Fun Gone?*, ECONOMIST, Mar. 20, 2004, at 94. Institutional Shareholder Services materials can be found at <http://www.issproxy.com/index.jsp>.

¹⁷⁸ See Healy & Palepu, *supra* note 119, at 14.

b. External Auditors

According to several accusations, Enron's former external auditors, Arthur Andersen LLP, used lax standards and thus attempted to conceal Enron's fraudulent transactions.¹⁷⁹ Similarly, Parmalat's former accountants, Grant Thornton and Deloitte, have been sued by Enrico Bondi, Parmalat's new special administrator, for allegedly helping the former Parmalat management team execute and conceal the fraud.¹⁸⁰ In particular, Parmalat executives, such as CFO Tonna and internal accountant Bocchi, have testified that the chairman of Grant Thornton's Italian affiliate and the lead partner on the Parmalat audit were aware of the true financial status of the company and repeatedly helped Parmalat's management set up its fraudulent schemes.¹⁸¹ Although this testimony and the defenses of the accused parties are still being considered by judicial authorities, Grant Thornton's Italian affiliate has suffered consequences from its affiliation with Parmalat. In fact, Grant Thornton International expelled its Italian affiliate from its global network, probably in an effort to disclaim any involvement with its former Italian affiliate, which was renamed Italaudit S.p.A. just to be safe.¹⁸²

Bondi also claims that Deloitte was aware of at least some of the problems at Parmalat and "ignored repeated clear warnings from member firms around the world."¹⁸³ But Deloitte's involvement does not appear to be as extensive as Grant Thornton's. Deloitte was hired in accordance with an Italian law¹⁸⁴ that requires a company to switch external

¹⁷⁹ *Id.* at 15.

¹⁸⁰ David Reilly & Alessandra Galloni, *Parmalat Sues Two Former Auditors for \$10 Billion*, WALL ST. J., Aug. 19, 2004, at A3 [hereinafter Reilly & Galloni, *Parmalat Sues*].

¹⁸¹ See, e.g., CAPOLINO ET AL., *supra* note 16, at 115, 124.

¹⁸² See Reilly & Galloni, *Parmalat Sues*, *supra* note 180.

¹⁸³ *Id.*

¹⁸⁴ Legislative Decree No. 58 of 24 Feb. 1998, §159, Gazz. Uff. No. 71 of 26 Mar. 1998, available at <http://www.parlamento.it/parlam/leggi/deleghe/98058dl.htm> [hereinafter *Draghi Reform*].

auditors every nine years.¹⁸⁵ So, while Deloitte became Parmalat's chief auditor in 1999, Parmalat circumvented the law by assigning Grant Thornton to audit most of the Group's offshore entities. Therefore, to certify the financial statements of the entire Parmalat Group, Deloitte relied extensively on representations made by Grant Thornton. According to the testimony of some Parmalat executives, Parmalat created the Bonlat "accounting dump" with Grant Thornton's assistance to hide fraudulent transactions from Deloitte auditors.¹⁸⁶ Also, Deloitte's refusal to certify Parmalat's financial statements in October 2003 eventually led to the discovery of the fraud.¹⁸⁷ These considerations greatly weaken Bondi's case against Deloitte.

But in addition, Bondi has accused Deloitte of repeatedly ignoring warnings from its member firms around the world. In its four years as chief auditor of Parmalat, Deloitte's Italian arm received several warnings from auditors in Deloitte's international network about transactions involving Bonlat and other offshore entities.¹⁸⁸ Deloitte's Italian arm refused to investigate the warnings further and expressed its concern that Parmalat might drop Deloitte as an auditor if it attempted to raise a red flag over the questionable transactions.¹⁸⁹

Regardless of where the blame falls, the relationship between Parmalat and its auditors is a perfect example of the principal/agent problem that afflicts gatekeepers in corporate governance systems. As Professor Coffee defines them, "gatekeepers are reputational intermediaries who provide verification and certification services to investors."¹⁹⁰

¹⁸⁵ See Melis, *supra* note 12, at 482.

¹⁸⁶ Alessandra Galloni & David Reilly, *Auditor Raised Parmalat Red Flag*, WALL ST. J., Mar. 29, 2004, at A3 [hereinafter Galloni & Reilly, *Red Flag*].

¹⁸⁷ See *supra* Part III.B for further discussion.

¹⁸⁸ Galloni & Reilly, *Red Flag*, *supra* note 186, at A3.

¹⁸⁹ *Id.*

¹⁹⁰ John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403, 1405 (2002) [hereinafter, Coffee,

Auditors, rating agencies, securities analysts, investment bankers, and lawyers can be gatekeepers. In general, a gatekeeper "vouches for the corporate client's own statements about itself or a specific transaction."¹⁹¹ Although professional gatekeepers are typically paid by the clients they monitor, the market generally trusts gatekeepers because a gatekeeper's reputation is at stake whenever it renders services. Because the value of a gatekeeper's services depends on its reputation, and as it has generally invested in building "reputational capital" over time, the market believes that a gatekeeper is not willing to risk its accumulated goodwill for a single client.¹⁹²

Still, "reliance on gatekeepers can prove to have been misplaced for a series of reasons."¹⁹³ One such reason is the principal/agent problem. The principal/agent problem arises when the interests of the agent (e.g., an employee) conflict with the interests of his or her principal (e.g., an employer). In the context of gatekeepers, this problem is intensified if the agent, a partner in a large international gatekeeping organization (the principal), is assigned one major client to which he must devote all of his time and attention.¹⁹⁴ In that case, since the partner has a "one-client" practice, he has a much stronger incentive to satisfy his client even if it involves deviating from the efficient norm of conduct. In fact, if the partner decides not to satisfy the client's request, the client might threaten to forego the partner's services (as in Parmalat's alleged threat to Deloitte), in which case the partner might lose his largest client and source of revenue. Confronted with that threat, the partner might be willing to risk the reputational capital of his entire firm; after all, if he loses the client, he basically loses his job as well. This logic

Gatekeepers]. See also Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 888-96 (1988).

¹⁹¹ See Coffee, *Gatekeepers*, *supra* note 190, at 1405.

¹⁹² *Id.*

¹⁹³ See Coffee, *Reform*, *supra* note 13, at 310.

¹⁹⁴ *Id.* at 322. See also Kraakman, *supra* note 190, 888-96.

clearly applied to David Duncan, Arthur Andersen's Houston partner in charge of the Enron audit team.

In theory, gatekeepers must be independent from their clients. Ideally, their independence should encompass both professional and legal dimensions. Professional independence refers to the notion that the gatekeeper's interests should be neutral in relation to any impacts on the client's business brought about by the gatekeeper's performance of its job. If the gatekeeper has a stake in the success of his client (for example, if the gatekeeper needs the client to do well so that its services will be required again in the future), he will be reluctant to perform his duty when doing so obstructs the client's business performance. Legal independence means that the gatekeeper should not worry about facing legal liability for performing his job properly, even if doing so uncovers illegal behavior by the client. If, by carrying out his obligations, the gatekeeper is likely to uncover past wrongs for which he could be held legally liable, he is less likely to execute his duty.

A significant concern with respect to the principal/agent problem in one-client practices is that it makes the gatekeeper professionally dependent on its client. If the pressure to satisfy the client's illegal demands is too high, the gatekeeper will succumb and partake in the fraudulent behavior. At this point, a vicious cycle begins. Because the gatekeeper has broken the law, its legal independence has been compromised as well. If the gatekeeper decides to reveal the client's fraud, its own past illegal behavior will be uncovered, and the gatekeeper will face potential legal liability. Therefore, a one-client practice creates a conflict of interest that makes a single gatekeeper much more likely to risk his firm's reputational capital in order to satisfy the client.

The principal/agent problem described above is common to all gatekeepers. For example, as is briefly explained below, one could argue that Parmalat's lawyer and several bankers who worked for Parmalat succumbed to the problem too. In the case of the auditors, the one-client practice would seem to explain the alleged willingness of the individual

Arthur Andersen, Grant Thornton, and Deloitte partners to help their clients defraud shareholders and creditors. Also, many critics have pointed out that in the past decade, accounting firms have provided more consulting services and have blamed the increase in non-audit services for the willingness of accountants to certify questionable financial statements.¹⁹⁵ While it is true that providing non-audit services can exacerbate the principal/agent problem, the problem exists even in the absence of this circumstance. For example, Parmalat's accountants never provided consulting services in addition to their auditing work.¹⁹⁶

It is clear that gatekeeper failures afflict both Europe and the United States.¹⁹⁷ Regardless of who is ultimately held responsible in the Enron and Parmalat cases, one lesson that can be drawn from comparing these cases is the relevance of the principal/agent problem in the context of professional gatekeepers. In particular, in both cases, the failures of external accountants can be explained by deficiencies in the structure of the accounting firms' internal controls. The principal/agent problem is created and shaped by the structure of the firm, so it seems natural to look first for structural solutions. In large accounting firms, top management depends almost entirely on the "lead audit partners" for information on clients.¹⁹⁸ This reliance is problematic since, in large accounting firms, most partners have only one client, giving rise to the conflict of interests discussed above. Indeed, both David Duncan of Arthur Andersen and the partners of Grant Thornton and Deloitte

¹⁹⁵ Joel S. Demski, *Corporate Conflicts of Interests*, 17 J. ECON. PERSP. 51, 56-59 (2003).

¹⁹⁶ John Gapper, *Parmalat Auditors Are Not Entirely To Blame*, FIN. TIMES (LONDON), Dec. 30, 2003, at 15.

¹⁹⁷ See Coffee, *Reform*, supra note 13, at 333.

¹⁹⁸ Jonathan Macey & Hillary A. Sale, *Lessons from Enron, How did Corporate and Securities Law Fail? Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1167-68 (2003).

who supervised the Parmalat audits had one-client practices.¹⁹⁹

This principal/agent problem could potentially be addressed by exercising greater centralized control over the individual partners dealing with large clients. Yet the largest accounting firms are structured as limited liability partnerships ("LLP"). The LLP structure protects partners by insulating their personal assets from potential liability. By doing so, it decreases partners' economic incentives to monitor each other effectively.²⁰⁰ In both scandals, the local audit teams were somehow able to ignore with impunity the red flags raised by other partners in their firms.²⁰¹ For example, in the Enron case, David Duncan of Arthur Andersen testified that he "rejected or ignored advice to change the accounting treatment of the Enron transactions" because "[h]e needed the client to maintain his pay and status at Andersen."²⁰²

The conflicts of interest created by firm structure are particularly relevant for accounting firms that operate on an international scale. The Big Four accounting firms are each structured as a network of "individual firms organized under the laws of each of the countries in which business is done as well as an umbrella entity with which the individual, country-specific firms are affiliated."²⁰³ On the one hand, these large accounting firms market their services by emphasizing their "global reach."²⁰⁴ Emails and documents used to pitch Deloitte's services to Parmalat show that Deloitte's Italian arm "presented itself as an integrated international firm able to tackle the finances of a complex

¹⁹⁹ *Id.* at 1170.

²⁰⁰ *Id.*

²⁰¹ Macey & Sale, *supra* note 198, at 1180; See Galloni & Reilly, *Red Flag*, *supra* note 186, at A3.

²⁰² Macey & Sale, *supra* note 198, at 1179-80.

²⁰³ Bondi v. Grant Thornton Int'l (*In re Parmalat Secs. Litig.*), No. 04 MD 1653, 2005 WL 1529035, at *1 (S.D.N.Y. June 18, 2005).

²⁰⁴ Deloitte Touche Tohmatsu Home Page, <http://www.deloitte.com> (last visited Nov. 6, 2005) (boasting the motto "Global reach, local solutions").

multinational organization.”²⁰⁵ In fact, once Parmalat hired Deloitte, it relied on services provided by Deloitte units in at least thirty countries.²⁰⁶ On the other hand, when sued for the alleged misdeeds of one of their units, the Big Four have promptly emphasized the independence of the global firm from the unit accused of illegal conduct.²⁰⁷ In the Parmalat case, the Deloitte partners working with Parmalat have been accused of ignoring red flags raised by member units around the world.²⁰⁸ To insulate its other units from potential liability arising out of the actions of its Italian arm, Deloitte described itself as “a network of affiliated but legally separate, national partnerships,” and claimed that “Deloitte Touche S.p.A., its Italian arm, bears sole responsibility for the audit.”²⁰⁹

Ironically, Deloitte’s defense highlights what is wrong with the internal structure of large accounting firms.²¹⁰ As explained above, the principal/agent problem arises primarily in the context of a one-client practice. Although the problem can attain global significance, as in the case of

²⁰⁵ David Reilly & Alessandra Galloni, *Divided Front: Facing Lawsuits, Parmalat Auditor Stresses Its Disunity*, WALL ST. J., Apr. 28, 2005, at A1 [hereinafter Reilly & Galloni, *Divided Front*].

²⁰⁶ *Id.*

²⁰⁷ *Id.* (to date, the arguments of the Big Four have been backed by courts in the United States).

²⁰⁸ Galloni & Reilly, *Red Flag*, *supra* note 186, at A3.

²⁰⁹ Reilly & Galloni, *Divided Front*, *supra* note 205, at A1.

²¹⁰ *In re Parmalat Secs. Litig.*, 2005 WL 1529035, at *1 (“Deloitte and other such organizations consist of individual firms organized under the laws of each of the countries in which business is done as well as an umbrella entity with which the individual, country-specific firms are affiliated. In Deloitte’s case, [Deloitte Touche Tohmatsu (“DTT”)] is the umbrella organization, and it is organized as a *verein* under Swiss law, a form of business organization that DTT asserts is analogous to an incorporated membership association. According to DTT, it ‘does not control its member firms’ and performs no accounting or auditing services. DTT acknowledges that most of the jurisdictions in which its member firms practice have accounting rules that prohibit an accountant from sharing client documents, even with the client’s permission, and it claims that ‘DTT is required by its own organizational documents to respect the independence of its member firms.’” (footnotes omitted)).

Arthur Andersen, the issue arises locally at the level of the one-client partner. In order to ensure that the one-client partner does not bow to the mischievous demands of his client, a firm must take decisionmaking power regarding a particular client away from the one-client partner and grant it to partners immune from such influence. In the Deloitte case, there is evidence that Deloitte's international units flagged issues in Parmalat's financial statements. But at the same time, as evidenced by the firm's defense at trial, the Italian unit enjoyed so much independence that it was able to ignore the concerns of its international colleagues.²¹¹ Ironically, while Deloitte should have kept its network of offices more cohesive to ensure tighter controls, its legal defense points precisely to the disunity among the firm's units.²¹² In both scandals, the internal structure of the accounting firms first created the principal/agent problem by encouraging individual partners to develop one-client practices. Then, the firm structure failed to provide an effective check on partners with one-client practices since the LLP structure decreased the incentives of partners to monitor each other, and local audit partners were left free to ignore advice from other partners.

The United States Congress responded to the Enron scandal by passing the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").²¹³ Among other provisions, Sections 101, 103 and 203 of Sarbanes-Oxley: (1) created an "Accounting Oversight Board" with substantial power to regulate the role of accountants for public companies; (2) developed more fully a set of duties of care for audit firms; and (3) imposed rotation requirements on auditors.²¹⁴ The Accounting Oversight Board and the development of a more extensive duty of care were specifically designed to counteract the

²¹¹ *Id.*

²¹² For a detailed account of Deloitte's defense, see generally *In re Parmalat Secs. Litig.*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005) and *In re Parmalat Secs. Litig.*, 2005 WL 1529035, at *1.

²¹³ See generally Sarbanes-Oxley Act of 2002, 15 U.S.C. §7213 (2002) [hereinafter Sarbanes-Oxley Act]

²¹⁴ *Id.* at §§ 101, 103, 203; Macey & Sale, *supra* note 198, at 1182-5.

types of principal/agent problems described above. In particular, by requiring accounting firms to establish a system of peer review and to report on their efforts to establish and to improve internal controls, Congress clearly meant to improve auditors' internal controls.²¹⁵

Similarly, Section 203 of Sarbanes-Oxley tried to solve the one-client practice problem by prohibiting accounting firms from providing audit services to any client if the lead audit partner provided services to that client in each of the last five years.²¹⁶ In theory, forcing accounting firms to rotate lead audit partners reduces the incentives of reviewing partners to fulfill the client's illegal requests. If a partner knows that she will be forced to switch clients after a few years, she might be unwilling to help her client act illegally, because she knows that her professional future is not completely dependent on her relationship with that specific client. Also, the mandatory rotation system increases the chances that a new lead audit partner will discover any fraud perpetrated by the previous lead audit partner.

Nevertheless, an examination of the Enron and the Parmalat fraud schemes casts some doubt on the effectiveness of Section 203. As briefly noted above, Italy required auditor rotation back in 1998 by passing the Draghi Reform.²¹⁷ Interestingly, while Sarbanes-Oxley only requires accounting firms to rotate lead audit partners working for a specific client, the Draghi Reform goes even further by imposing a nine-year limit on the length of time for which an

²¹⁵ Sarbanes-Oxley Act §103(a)(2)(A)(i)–(ii).

²¹⁶ See *id.* §203. Section 203 of Sarbanes-Oxley provides: "Section 10A of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following: '(j) Audit Partner Rotation.-- It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the five previous fiscal years of that issuer.'" See also Macey & Sale, *supra* note 198, at 1187.

²¹⁷ See generally *Draghi Reform*, *supra* note 184.

auditing firm can audit the books of a specific company.²¹⁸ This explains why Parmalat was forced to hire Deloitte to replace Grant Thornton as auditor of the holding company for the Parmalat Group. Under Sarbanes-Oxley, Enron would not have been required to switch auditors, and Arthur Andersen would have been required to rotate only the lead audit partner. Nevertheless, Parmalat was able to circumvent the Draghi Reform by employing Grant Thornton as auditor of its controversial offshore subsidiaries. Given the failure of the stricter Section 159 of the Draghi Reform, it seems legitimate to question the potential effectiveness of Section 203 of Sarbanes-Oxley. Furthermore, as Macey and Sale point out:

If client satisfaction remains as dominant a factor in evaluating partners, rotating partners may be an insufficient response. Each partner may be willing to accept some pressure from clients in order to protect their own status within the firm, and a "whistle-blowing" partner does not stand much to gain from doing so. Thus, in a world where client satisfaction remains a dominant measure of partner performance, [Section 203 of Sarbanes-Oxley] could actually prompt a race to the bottom.²¹⁹

Only time will tell whether the establishment of the Accounting Oversight Board and the development of a more extensive duty of care pursuant to Sections 101 and 103 of Sarbanes-Oxley will provide an effective solution to the principal/agent problems present within accounting firms. However, an analysis of the regulatory framework within which the Parmalat fraud developed offers a reason to question the effectiveness of Sarbanes-Oxley's audit partner rotation requirement.

²¹⁸ *Id.*

²¹⁹ Macey & Sale, *supra* note 198, at 1185-6.

c. Investment Bankers

In the Enron scandal, many have criticized investment banks for both assisting Enron in setting up its controversial SPEs, and in some cases, investing in them.²²⁰ In June 2005, Citigroup agreed to a \$2 billion settlement in connection with the Enron case, and other banks may soon follow Citigroup's lead.²²¹ Investment bankers seem to be attracting even more attention in the Parmalat context. In fact, the behavior of several of the investment bankers who dealt with Parmalat has been seriously called into question. Some of the biggest banks in the world, such as the Italian unit of Bank of America Corp., Citigroup Inc., Deutsche Bank AG, UBS AG, and Morgan Stanley, are subject to investigation by Italian authorities.²²² Several other banks, such as Credit Suisse First Boston, Citigroup, and Bank of America, have been sued directly by Enrico Bondi, Parmalat's new special administrator, who has been trying to collect several billion dollars in damages.²²³ In June of 2005, Morgan Stanley became the first bank to settle with Parmalat for \$188 million.²²⁴

In general, prosecutors will attempt to determine whether banks knew or should have known about Parmalat's true financial status. For example, Enrico Bondi has accused banks of failing to identify a simple red flag that should have alerted them to Parmalat's financial troubles. According to

²²⁰ Kuney, *supra* note 143, at 884.

²²¹ Julie Creswell, *Citigroup Agrees to Pay \$2 Billion on Enron Scandal*, N.Y. TIMES, June 11, 2005, at A1.

²²² Alessandra Galloni & David Reilly, *Milan Officials Are Expanding Parmalat Probe*, WALL ST. J., Oct. 22, 2004, at A9 [hereinafter Galloni & Reilly, *Parmalat Probe*].

²²³ Eric Sylvers, *Parmalat Sues 45 Banks to Recover \$4 Billion*, N.Y. TIMES, Dec. 17, 2004, at W1. See also *Parmalat Sues More of Its Banks*, WALL ST. J., Aug. 25, 2005, at C4; Serena Saitto, *Parmalat Sues J P Morgan Chase and Unicredito*, WALL ST. J., Aug. 8, 2005, at A8; *Parmalat Finanziaria SpA: Intesa and Unicredito Unit Are Sued Over Bond Role*, WALL ST. J., Aug. 29, 2005, at C3.

²²⁴ *Morgan Stanley Sets Parmalat Deal*, WALL ST. J., June 24, 2005, at C3.

Bondi, there was a clear mismatch between Parmalat's debt as reported on its balance sheet and the amount that the Bank of Italy had in its lending register.²²⁵ Not surprisingly, Citigroup quickly denied Bondi's allegations and defended its own dealings with Parmalat.²²⁶

As it is too early to assess guilt at this point, the blame game among investment banks will play out in the courts. It is possible that some investment bankers might have been affected by a principal/agent problem similar to the one described above. Indeed, several Arthur Andersen accountants became so close to Enron's management that they left their company to join Enron,²²⁷ just as at least two of Parmalat's investment bankers who worked extensively with Parmalat's management chose to join Parmalat. Both Alberto Ferraris, a former employee of Citigroup who had worked with Parmalat on the audacious Buconero transaction, and Luca Sala, a former Bank of America employee who later was arrested after admitting to siphoning off \$20 million of Parmalat's funds to his personal account, joined Parmalat's management.²²⁸ Although it might be customary to recruit executives from banks with whom a company has completed successful transactions, these movements also illustrate how strong professional dependence on a single client can become. Certainly, if a gatekeeper knows that maintaining a strong relationship with a client might eventually lead to an in-house position, he or she might be more willing to bend to the illegal requests of that client.

d. Lawyers

While the role of Enron's attorneys, Vinson & Elkins, has not yet been deemed relevant to the scandal (at least in

²²⁵ David Reilly, *Moving the Market: Citigroup Says Parmalat Woes Weren't Obvious*, WALL ST. J., Nov. 1, 2004, at C3.

²²⁶ *Id.*

²²⁷ Kuney, *supra* note 143, at 882.

²²⁸ Gumbel, *supra* note 41, at A2.

comparison to the role of its auditors and bankers),²²⁹ Gian Paolo Zini, the founding partner of Parmalat's counsel, Zini & Associates, has been under investigation for his role in Parmalat's fraudulent transactions.²³⁰ In Milan, Zini has already been convicted and sentenced to two years in prison²³¹ and his law firm is facing a pending class action lawsuit in the United States as of September 2005.²³² In his testimony, Tonna repeatedly accused Zini of being an active participant in Parmalat's fraud, as exemplified by his assistance in the creation of the Epicurum Fund.²³³ Zini's participation in the Parmalat scandal may again be explained by the pressures of a one-client practice. Indeed, Parmalat was by far Zini's largest client, if not his only client. Accordingly, Zini himself has been accused of acting more like a member of Parmalat's management (for example, serving as a contact for banks and moving funds) than as a neutral outside attorney—a stark example of gatekeeper failure.²³⁴

2. Demand Side

a. Sell-side analysts

Similar to the Enron case, in which sell-side analysts failed to detect Enron's problems, the Parmalat fraud eluded analysts for over a decade. Until October 2001, sixteen of the seventeen analysts covering the company maintained a

²²⁹ Kuney, *supra* note 143, at 883.

²³⁰ Jonathan D. Glater, *Law Firm for Parmalat Under Scrutiny*, N.Y. TIMES, Feb. 21, 2004, at C1.

²³¹ Sylvers, *Sentencing*, *supra* note 59, at C6.

²³² See generally *In re Parmalat Secs. Litig.*, 383 F. Supp. 2d 616 (S.D.N.Y. 2005) (dismissing the 10b-5 claims against Zini's law firm, but denying part of the law firm's motion to dismiss in holding that disputed issues remained as to whether the law firm controlled the shell companies to further the client's fraud).

²³³ See CAPOLINO ET AL., *supra* note 16, at 189.

²³⁴ *Id.*

“buy” or “strong buy” recommendation on Enron’s stock.²³⁵ This naturally begs the question: How could Parmalat’s fraud go undetected for so long? Furthermore, why did analysts not realize that there was something suspicious about Parmalat’s success?

A natural response is that analysts received fraudulent information. The company’s misleading financial statements painted a completely distorted picture and analysts could not have detected Parmalat’s problems from the false data that they were given. While this argument is superficially reasonable, Parmalat’s strange operational and financing decisions should have raised some red flags. For example, for many years Parmalat borrowed substantial sums of money at high interest rates despite showing billions of euros in liquidity on its books. Strangely, analysts never voiced their concerns about this type of borrowing behavior. Nor did they ask Parmalat how it used all of the loan proceeds. The fact that the same firms that rated Parmalat’s stock also competed to provide Parmalat with their investment banking services further compounded matters. Some have argued that the Parmalat debacle can be blamed in part on failure of the “Chinese Walls” that exist within the investment banks to avoid collusion between their sell-side research and investment banking operations.

However, it is difficult to believe that the sell-side analysts were so compromised by their employer’s desire to provide investment banking services to Parmalat that they granted undeservedly optimistic ratings for Parmalat’s stock. Some analysts did pick up on Parmalat’s problems. Most notably, Joanna Speed, a Merrill Lynch analyst, issued a “sell” recommendation on Parmalat stock in December 2002, over a year before the scandal unfolded.²³⁶ In a May 13, 2003 report on Parmalat, Speed expressed her concern “as to the underlying cash generation of the [G]roup and where the

²³⁵ See Coffee, *Reform*, *supra* note 13, at 316.

²³⁶ See Gumbel, *supra* note 41, at A2.

cash [was] going.”²³⁷ She remained “cautious as to the [G]roup’s capital structure and balance sheet management” and continued “to view the [G]roup’s disclosure as poor, particularly with respect to cash flow and total debt position.”²³⁸ It is striking to observe how accurate Speed was in her assessment of Parmalat’s financial problems. The question becomes: if the publicly available data was sufficient to lead one analyst to question Parmalat’s statements, why did more analysts not voice their concerns? Perhaps, while Speed was not afflicted by the myopia that affected other analysts, the conflicts of interest that existed overwhelmed the independence of most sell-side research divisions. Or perhaps the Parmalat fraud illustrates the tendency of sell-side analysts to “herd” and follow the general consensus of sell-side research.²³⁹ Whatever the reason, sell-side analysts failed to uphold their gatekeeping duties. And if the problem is that sell-side analysts cannot be trusted due to the perverse incentives that affect them, to what extent can a solution be provided by greater reliance on market rankings of sell-side analysts based on the performance of their forecasts?²⁴⁰

b. Rating Agencies

Rating agencies also provide an arguably reputable intermediate assessment of companies. Although they are paid by the same company that they evaluate, their reputation, and thus their survival, depends on the neutrality of their assessment. In both the Parmalat and Enron scandals, rating agencies played a key role in revealing the companies’ frauds. In fact, by lowering each company’s debt rating from “investment grade” to “junk”

²³⁷ Joanna Speed, Merrill Lynch, *Flashnote: Parmalat’s 1st Quarter Financial Report of 2003*, May 13, 2003, available at <http://www.borsaitalia.it/media/star/db/pdf/17545.pdf>.

²³⁸ *Id.*

²³⁹ See Coffee, *Reform*, *supra* note 13, at 330.

²⁴⁰ For an example of a private source of rankings of sell-side analysts, see, e.g., StarMine Corp., available at <http://www.starmine.com/>.

status, they effectively condemned the company to bankruptcy. Like the stock analysts, the rating agencies should have been able to detect Enron's and Parmalat's financial problems sooner, and downgraded the debt ratings of the companies sooner.

Another group of authors discount the importance of the rating agencies' role as gatekeepers,²⁴¹ despite the fact that a downgrade by a rating agency can have devastating effects. Since credit rating agencies are aware that a downgrade might send a company into bankruptcy court, they might be extremely reluctant to downgrade a company's debt rating. Their unwillingness to respond promptly to the questionable behavior of the company they monitored undermines their value as gatekeepers.²⁴²

c. Investors

In both the Enron and Parmalat cases, investors failed to perceive that the companies' stocks were overvalued. When Enron's stock price reached its peak, approximately 60% of the outstanding shares were held by institutional investors, whereas institutional investors never owned more than 5% of Parmalat's shares.²⁴³ Yet, many of Parmalat's debt and equity securities were issued to institutional investors. In theory, when institutional investors hold a substantial stake in a company, they have an incentive to monitor the behavior of management, to require greater disclosure, and to sell securities that they consider to be overpriced. In both cases though, institutional investors failed to act as watchdogs for smaller investors.

²⁴¹ Jonathan R. Macey, *A Pox On Both Your Houses: Enron, Sarbanes-Oxley And the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 342 (2003).

²⁴² *Id.*

²⁴³ See Commissione Nazionale per Le Società e la Borsa, Azionisti Rilevanti Della Parmalat Finanziaria SPA, *supra* note 134.

V. CONCLUSION

This Note has argued that the Parmalat fraud was substantially affected by some distinctly European factors. Most importantly, unlike Enron and most large U.S. companies, Parmalat was owned and controlled by its founder, Calisto Tanzi, who exercised complete dominion over the company. This difference in the ownership structures of Enron and Parmalat presented disparate governance problems for each company. While Enron's management acted with self-interest to the detriment of the investors, in Parmalat, the controlling shareholder personally looted the assets of the company. Moreover, while greed was the driving force behind the Enron scandal, much of the Parmalat fraud was an attempt to keep a technically insolvent company afloat. This desire resulted from two factors: first, Parmalat had been a family business for forty years, so it is reasonable to assume that Tanzi did not want it to go bankrupt; and second, given the relatively small Italian social and political scene, for Tanzi, losing Parmalat would also have meant losing his social status and his political connections.

As far as the means used to defraud are concerned, both the Parmalat and the Enron schemes were rather complex and involved sophisticated structured finance transactions. The main difference between the two scandals is that Parmalat's fraud was ultimately grounded in the simple forgery of financial documents. While Enron's management pushed the accounting rules to their limits, Parmalat brazenly made up bank accounts worth billions of dollars.

This discussion also suggests that responsibility for the frauds cannot necessarily be assigned to individual culprits. The Parmalat fraud, like Enron's, demonstrated that the breakdown occurred at all levels of corporate governance and gatekeeping from the Board of Directors to sell-side equity research analysts. While it is still too early to reconstruct exactly what happened and who is to blame, the widespread failure of financial gatekeepers in both scandals allows us to draw one predominant conclusion: the principal/agent problem caused by gatekeepers with one-client practices is a

serious problem on both sides of the Atlantic. Regulators should direct their efforts toward this very problem.

Finally, there is a speculative answer to the question that has remained unanswered regarding the Parmalat scandal: How could a fraud (1) this big, (2) last for this long, (3) when so many professionals were exposed to it?

(1) *So big*: The scale of the Parmalat fraud did not escalate until the few years leading up to its discovery. It has been calculated that if Parmalat had gone bankrupt in 1995, "it would have been a mid-sized Italian failure with debts of about €560 million."²⁴⁴ Therefore, while it is true that Parmalat's fraud ultimately grew to considerable proportions, it is possible that it grew out of hand only one to two years before authorities actually discovered it.

(2) *So long*: It also has yet to be determined when the fraud actually began. While some sources argue that Parmalat officials began to conceal the company's financial difficulties when it went public in 1990, Tonna's testimony seems to imply that major adjustments to Parmalat's accounts did not begin until the South American crisis of 1998 and the creation of Bonlat.²⁴⁵ Thus, Parmalat's fraud may have been of a shorter duration than initially believed.

(3) *When so many knew*: While the number of people who were apprised of the scandal is unclear, a few considerations seem relevant. First, only people who had worked very closely with Parmalat's management might have been aware of the fraud. Second, even if many knew something, few likely recognized the full extent of the fraud. Those who did know potentially could have taken steps such as informing the authorities. However, this would not have been a wise course of action if, as most have assumed, the informant was either a Parmalat employee or one of the one-client service providers who depended on Parmalat's successful existence for their livelihood. A second alternative would have been to sell Parmalat's stock short, which, according to the efficient market hypothesis, might have eventually led to a decrease

²⁴⁴ See Gumbel, *supra* note 41, at A2.

²⁴⁵ See CAPOLINO ET AL., *supra* note 16, at 122.

in the value of Parmalat stock and thus alerted the market to Parmalat's troubles. It is possible that some insiders might have done just that, but it is very unlikely. In fact, selling short is a risky investment strategy and empirical data suggests that very few shares of stock are actually sold short.²⁴⁶ In this case, even if an investor had been aware of the fraud, she might not have been aware of its full extent, thereby creating some uncertainty concerning the underlying value of the company. Even if such an investor had been completely certain that the stock price was overvalued, it was uncertain when the market would reflect this information.²⁴⁷ Since Parmalat was an industrial giant, it seems reasonable to assume that people who did not know the true extent of the fraud might have thought that the company would have continued to operate indefinitely, delaying a stock price decline. If so, very few would have sold the stock short, even if aware of the fraud.

A final consideration ties in to the earlier discussion regarding the social dimension of the Parmalat scandal. Tanzi was a very powerful and connected personality. He had powerful politicians on his side, and one cannot disregard the possibility that his connections afforded him some immunity from regulatory controls, at least in Italy. Certainly, given Tanzi's power (and the thousands of local citizens who depended on Parmalat for their livelihood), anybody in Collecchio or Parma would have thought twice about reporting Parmalat's misdeeds to the authorities.

²⁴⁶ See Macey, *supra* note 241, at 346.

²⁴⁷ A possible approach would have been to sell the stock short and then to inform the judicial authorities. Again, such a strategy would have involved a great deal of risk due to the uncertainty regarding the reaction of the authorities, their timing, and the reaction of the market.