

# **“Control fraud” at Rite Aid**

Markkula Center for Applied Ethics

William K. Black

Exec. Director, Institute for Fraud Prevention

Associate Prof. of Economics & Law, UMKC

# Sources

I have drawn on many sources for this presentation, but the quotations are overwhelmingly from the indictment of Martin Grass and “Prescription for Disaster” by David Callahan in *Baltimore Smart CEO* (January 2004).

# What is “control fraud”?

The person controlling the firm, typically the CEO, uses it as a “weapon” to defraud others.

Exploits the firm’s power and apparent legitimacy.

Produces by far the largest losses of any property crime.

# Why are “control frauds” so harmful

Only the CEO can twist “controls” into fraud allies, optimize firm ops as a weapon for fraud & change the external environment to aid fraud.

Martin Grass: “Things only go smoothly if you control the people that work for you.” Control frauds are control freaks.

# Rite Aid's Origins

1960: Sup. Ct. strikes down “fair trade” laws: allows discount retail

Rite Aid: discount drug store chain. First store opened in 1962.

Family feuds begins promptly.

# Family feuds

Alex Grass was trained as a lawyer,  
but worked in in-law's food business

Opens drug store in 1962 w/ Lehrman  
family – his in-laws

Shared passions: \$ & GOP

Fight with Lehrmans leads to divorce  
with their daughter & problem kids

# Alex Grass stokes the feud

Lewis Lehrman: 1982 contender for  
GOP nominee as NY governor

Ads tout success as Rite Aid exec

Grass ads attack Lehrman and claim  
credit for Rite Aid's success

# His sons plot a coup

IPO (1968) made Alex rich

Groomed Martin (MBA: Cornell) as successor – reluctant to cede power

1988: Martin (35) & Robert (33) plot w/ Milken (Drexel) to take over Rite Aid

Alex forces Robert out



# 1989: Bad from the start

Martin is named Rite Aid's president  
Caught in a sting allegedly seeking to  
bribe Ohio pharmacy board member  
Beats rap, but \$2.5M legal fees to RA  
“When somebody comes at you ...  
you have to retaliate”: Martin Grass

# 1994: Martin made CEO

Promptly plots v. Alex

February 1995: Board asks for Alex's resignation

Martin made CEO & COB

“Disses” dad to credulous fin. mkts.  
as too fearful to grow & leverage

# What's going on here?

Hell hath no fury like the son of a woman scorned (or betrayed)

Dad taught Social Darwinism. Roger: "Dad...you made money the currency of love." (Sis is also a problem child.)

Their in-laws and dad's feud taught them that its kill or be killed when it comes to controlling a corporation

# Martin's martial mantra

“Well, buddy, the moment of truth has come.... I’m knocking dad out of the box. It’s going down tomorrow.”

# But they're religious and philanthropists!

Humans are complicated: gray

Neutralization: it's common for elite criminals to contribute. It helps them look in the mirror.

Charitable & political contributions aid “control frauds.” Enhance status, power & apparent legitimacy.

# Corrupt corporate culture

Robert Grass: “If you work in an environment that says, ‘kill anyone, kill anything’ that’s what happens.”

“Once you’ve got them by the balls, they’re hearts and minds will follow.”  
(Sign in RA board member’s office.)

# Martin's plan: growth & debt

Despite the MBA, there's no career evidence of business competence

Nepotism explained his high position

Willing to betray his dad, but investors thought he'd be faithful???

Reputation was created by nasty PR attacking his dad & boosting him

The “experts” bought it hook,  
line, sinker, rod, reel & boat

Financial analysts praised Martin

Financial press gave him awards

Banks rushed to lend Rite Aid

Stock price surged

This all occurred as he made  
disastrous business decisions



# Merger dangers

Martin's plan: merge with Revco to pass Walgreens & be No. 1

DOJ blocked on antitrust grounds

Martin scrambled for a quick alternative, merged with a CA chain of much larger stores: mkts and stores RA didn't understand

# When did the frauds begin?

We don't know. The conventional story about Rite Aid is that there was one primary fraud designed to cover up its losses and an ancillary fraud involving self-dealing by Martin. But there are strong claims of earlier, broader frauds involving the board.

# Martin's deals with board members

Martin plainly made secret deals with board to force dad out

Martin had planned (with Drexel's aid) similar private deals with board members in his earlier, failed coup

Similar Drexel deals often involved securities fraud

# Whistleblower?

Martin fired Mann (procurement) and had him marched out of HQ

DOJ investigated Mann fearing fraud

Mann said this was due to retaliation by Martin and alleged fraud involving board members and Martin

# Confidential settlement

The comp. chair was notorious

Martin has Rite Aid enter into \$11 MM settlement of Mann's slander suit

Key term of deal: Mann cannot discuss or disseminate his charges of fraud and abuse by Rite Aid's leaders

The deal stalled bad press stories

# If Mann is correct:

There were many frauds

The frauds began at least as early as Martin becoming CEO

The board, particularly the head of the comp. comm., was not “merely” negligent but engaged in self-dealing

Martin was manipulating stock options from the beginning w/ comp. chair

# Conventional story:

Poor merger decision and  
implementation leads to losses

No fraud at this juncture

Two variants of origins of fraud:

Martin: pressure of meeting “the #”

Prosecutors: driven by bonuses

# Martin: I did not profit

I had no interest in self-gain

I did not sell any shares

I intended the best for the corporation  
and shareholders

I tried to grow too fast

Had to “make the #” to protect stock  
price for investors



# Prosecutors

Martin motivated by greed

Used accounting fraud to preserve his control and obtain bonuses

Designed comp to depend on “profits”

Engaged in self-dealing to profit

# How were the frauds done?

“Control frauds” involving Pharma are notorious

“Control frauds”: CEO uses the corporation as a “weapon”

“Looting” control frauds victimize creditors & shareholders

# Accounting fraud is a looter's weapon of choice

That has been true of all the major  
Pharma frauds

Typically engage in accounting fraud  
by manipulating inventory to profit  
and cover up loss

Rite Aid continued that pattern

# Accounting fraud creates false income & hides real losses

Inventory scams: Rite Aid recorded about \$75 million of vendor rebates in FY '99 (47% of its pretax income) and arbitrarily adjusted inventory losses from pilfering and damage by \$9M.

Non-inventory scams: scammed depreciation expense

# Rite Aid was an ethical swamp

Sold drugs past expiration date

Allegedly manipulated IT system to add an undisclosed \$1 fee to uninsured (i.e., poor) customers

Created own brand of low price cigarettes which it placed next to ads touting its anti-cancer efforts

“We’re going to have to get dirty here.” (RA’s CFO)

The cover up phase often creates the more easily proved crimes

CFO and Martin pressured Controller to falsify financial statements (Feb '99: end of FY)

He turned down a bonus and took medical leave for stress

# Led to defrauding vendors

Scammed rebate accounts

False deductions in payments to vendors for purportedly damaged goods

# Led to cover up payments

Backdated bonus agreements to top executives (including Mr. Noonan) to loot Rite Aid and provide hush men to try to prevent adverse testimony, producing further securities fraud

Noonan did not cash in on his backdated document



# Threats to KPMG

KPMG did not perform adequately

As Rite Aid's accounting fraud became more flagrant Martin feared KPMG would deny a clean opinion

Martin threatened to reveal "skeletons", tried to get audit partner fired, and hired them as consultants

# Destroying evidence

Martin (on tape when the FBI “wired” Mr. Noonan): “They do not have, and will not have the files, unless they use a Trident submarine.”

# Martin's real estate deal

Another in-law deal

50/50 real estate deal with brother-in-law, Tim Harrison

\$2.6M purchase funded by Rite Aid, w/ false claim that TH was sole owner

RA's GC later creates false contract for TH to hide Martin's co-ownership

# Hoisted on his own Helipad

A journalist tumbled to the real estate story because it involved a helipad

Martin was notorious for flying his jet chopper into neighborhoods at 3:00 a.m. rather than use a nearby airport

Rude, arrogant ... and loved by Wall Street and the financial press

# What ethical insights can we draw?

The key insights have little to do with the Grass family's moral failings

We know that greed + ambition w/o ethics = disaster

Nor is governance the issue: BOD was bad because control frauds pick board members that aid the frauds

# Compensation not the key

Yes, it's obscene that Martin was paid a fortune to loot "his" company

But control frauds that loot design their compensation systems to make themselves rich

Martin's side deals show there are many ways to loot beyond comp.

# Market pressure is bunk

Martin's attempt to blame the markets for his fraud is a lie and demonstrated his lack of remorse

He was trying to enrich himself

He designed a compensation system tied to short term "performance" because that is the easiest # to scam

# The ethical issues are us

Financial “experts” treated Martin as a “genius” when he was a classic, incompetent control fraud

Investors rewarded his frauds

The professionals aided his frauds

“High society” and politicians treated him as the crème de la crème



# Martin was easy to spot

If we can't stop massive, crude control frauds by CEOs *openly* devoid of ethics how can we claim to take ethics seriously?

We allow the worst among us to use the proceeds of fraud to *buy* a good reputation through contributions

# Greenspan on reputation

Alan Greenspan's standard speech was an ode to reputation: if a business person – even *once* – acted unethically he was ruined forever

Criminologists know this is a myth. Control frauds engage in hundreds of unethical acts – and elites aid them.

# Gresham's law: ethics

Gresham's law states that in hyper-inflations “bad money drives good money out of circulation.” When unethical acts create a business advantage over one's competitors bad ethical acts can drive good ethics out of the markets.

# So what will we do?

Control frauds are *our* problem

Big control frauds need the aid of elite professionals, elite banks & the fin.

Press. They need weak regulators.

Honest businesses, an independent fin. press & strong reg. can stop them