PONZI SCHEMES AND THE DARK SIDE OF ENTREPRENEURSHIP: ENTREPRENEURIAL SUBVERSIVE ISOMORPHISM

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Recommended Citation  
Available at: https://digitalknowledge.babson.edu/fer/vol36/iss16/2
ABSTRACT

This investigation of Ponzi schemes provides a foundation for new understanding of institutional theory. Constructs, antecedents, and theory that differ from the current view of isomorphism are explored through the content analysis of dozens of illegal entrepreneurs. The concept of subversive isomorphism: abusing one’s network to overcome the basic entrepreneurial condition of limited resources and low legitimacy is developed.

INTRODUCTION

Research investigating the informal economy has come to prominence in recent years as studies show that it may account for nearly half of the economic activity in developing countries (Godfrey 2011; Schneider 2007). Some estimates show that informal businesses are equal to $5 trillion annually (Fitch & Sorenson 2007). While a significant portion of this revenue is from base-of-the-pyramid activity in developing countries, the informal economy can also include up to 15% of overall economic activity in developed countries (Kistruck, Webb, Sutter, and Bailey 2014); For example, it has been estimated that 90% of construction sub-contracting in New York City and 15% of all employment in Los Angeles County is resident in the informal economy (Sassen-Koob 1989; Vogel 2006).

Entrepreneurs are the central actors in much of this space, (Bosma & Levie 2009) where they often encounter additional barriers due to the informal economy’s unregulated nature and the prevalence of a criminal element. Despite its size and importance, the unregulated, unregistered nature of the informal economy, combined with some illegal actors, makes it difficult to empirically study and conceptually understand (McGahan 2012; Webb Tihanyi, Ireland, & Sirmon 2009). Recently, however, an agenda for research is beginning to take form (Bruton, Ireland, & Ketchen 2012; McGahan 2012) and theory connecting institutional entrepreneurship and the informal economy is developing (Webb Tihanyi, Ireland, & Sirmon 2009). Within this burgeoning line of inquiry, scholars are clear to explain that the informal economy also includes an illegal faction that they further delineate and separate from the “legitimate” informal actors. However, just as McGahan (2012) directs us that there is much to be learned from not separating the informal from the formal economy, we wondered why the current entrepreneurship literature separates illegal entrepreneurs from the current inquiry.

There are two likely reasons for this exclusion: access and contribution. First, clearly, many illegal entrepreneurs – drug cartels, dog fighting syndicates, etc. – are unregistered and unregulated so they are difficult to track and study. Second, given that this subset of entrepreneurs includes
activities that blatantly cause harm (De Soto 1989) it is perhaps natural to assume that scholars and practitioners would have little, if anything, to learn from these actors.

Our study is designed to overcome the first concern and intends to shed new light on the second. While certain types of illegal entrepreneurial activity are difficult to study, the unfortunate recent rise in fraud, online crimes, and identity theft mitigate this challenge to a degree as this activity leaves a researchable trail. As for contribution – while recognizing the destruction that comes in the wake of illegal entrepreneurs – research suggests that studying this entrepreneurial element can further scholarship and benefit practitioners as well as the public (Croall 2013; Muhtaseb & Yang 2008). Our research design takes a grounded theory approach and qualitative analysis of the world’s largest Ponzi scheme ventures in order to understand how these entrepreneurs operate and how we might learn from them to better inform scholarship, practice, and pedagogy.

Our paper continues with a discussion of institutional theory and the informal entrepreneurial economy literature to provide a foundation and context for our work. We then explain our grounded theory approach and research design. Finally, we discuss our findings and their implications.

INSTITUTIONAL FRAMEWORK

Institutional theory (e.g., DiMaggio & Powell, 1983) provides a useful framework for examining illegal entrepreneurship since it theorizes that entrepreneurs will establish new ventures that look highly similar to existing firms in their industries (Deephouse, 1996; Deephouse & Suchman, 2008), enabling firms to survive and prosper. Survival is a critical goal of most entrepreneurs who start new ventures. Research indicates that survival may depend on an entrepreneur’s ability to establish the new venture’s legitimacy (McMullin & Shepherd, 2006), create a viable business model (Morris, Schindehutte & Allen, 2005) and ensure that the new venture’s finances are carefully managed to survive in the long term (Barringer & Ireland, 2012). Substantial research has been done using institutional theory to examine entrepreneurial ventures, showing that profit-seeking entrepreneurs can co-create the institutional environment in which they operate (Alvarez, Young & Woolley, 2015), develop legitimacy for novel forms of organizations in new, emerging industries (David, Sine & Haveman, 2013), and obtain superior performance by establishing higher levels of new venture legitimacy (Diez-Martín, Prado-Roman & Blanco-Gonzalez, 2013).

As such, legitimacy represents a key resource for entrepreneurs starting new ventures (Zimmerman & Zeit, 2002), including those entrepreneurs starting illegal ventures. Entrepreneurs starting and operating illegal ventures will therefore try to identify ways to build legitimacy as a key resource because doing so ensures profitability and longer-term survival. Institutional theory suggests that an effective way to do this involves adhering to institutional myths or organizational forms and practices viewed as appropriate and taken for granted (Meyer & Rowan, 1977; Aldrich & Fiol, 1994). Organizations can engage in strategic or deliberate actions to create legitimacy rather than having to passively accept institutional norms or myths of behavior (Oliver, 1991).

INFORMAL ECONOMY & ILLEGAL ACTIVITY

The informal economy is comprised of the economic activity of unregistered and unregulated firms and their interaction with their suppliers and customers (McGahan 2012). These firms operate outside of any governmental business regulations in a shadowy zone (Bruton et al. 2012) that tends to run parallel to the formal economy. The activity is widespread across all countries whether they are developed, developing, or under-developed (Godfrey 2011) and although it is
unregulated by the government much of the informal economy is highly structured (Hart 2006; Sindzringe 2006). These firms are responsible for trillions in business each year (Fitch & Sorenson 2007) and around 50% of the GDP in develop nations (Bruton et al. 2012). However, it is important to note that the informal economy is prevalent in the world’s most advance economies as well: it dominates the construction sub-contracting industry in New York City and is responsible for nearly 1 out of every 6 jobs in Los Angeles County (Sassen-Koob 1989; Vogel 2006).

Research on the informal economy and the entrepreneurs within it has grown in the last few years as researchers employ economic, sociological, and organizational behavior approaches to study this phenomenon (Bruton et al. 2012). Others argue that to truly understand the broad field of management the informal economy needs to be studied hand in hand with the formal (McGahan 2012). Webb and colleagues (2009) do just this as they study the role institutions and collective identity play in entrepreneurial activity within the informal economy. They then develop institutional categories of different entrepreneurial activities contrasting legal and illegal means and ends that exist in both the formal and informal economies. Their work goes a long way in helping scholars understand how informal firms develop and how some transition into the formal economy.

All of this burgeoning work on the informal entrepreneurial economy is silent on the illegal entrepreneurs that, just like the informal economy, are running parallel to the formal economy. Webb et al. (2012) refer to illegal entrepreneurs as a third renegade economy that uses illegal and illegitimate means to achieve illegal and illegitimate ends. Some scholars refrain from investigating these entrepreneurs because they are morally unacceptable and thus do not fit the current definition of the informal economy (Bruton et al 2012) or because they are designed to do harm (De Soto 1989). Others do note that illegal entrepreneurs and the “renegade economy is an intriguing research context” (Webb et al. 2009) suggesting that this “third economy” warrants more study.

Therefore, although institutional theory implicitly assumes that organizations pursue legal and ethical interests, we combine it with the work on informal economies to explain the behavior of illegal entrepreneurs and get a better picture of the entire economy. In line with institutional theory, some similarities exist between legal, illegal, and informal entrepreneurial ventures. However, new illegal ventures also face substantial uncertainty associated with operating outside of the law. Survival for illegal entrepreneurs hinges, in part, on avoiding detection and establishing the legitimacy of their ventures. The more illegal ventures can achieve “taken for granted” status as organizations in an industry (Aldrich & Fiol, 1994), the greater their legitimacy. In our study we then examine how these illegal entrepreneurs adopt institutional norms to achieve legitimacy. Our methodology is designed to allow us to uncover new theoretical insights to extend institutional theory.

**METHODOLOGY AND RESEARCH DESIGN**

Since little research has been done on illegal ventures, this study adopts a methodology similar to David et al. (2013), using rich qualitative data in a set of cases to build theory. Specifically, we examine how the entrepreneurial action of entrepreneurs allows for the establishment and ensure long-term survival of illegal ventures.

Our sample of illegal entrepreneurs comes from entrepreneurs who engaged in Ponzi schemes. Ponzi entrepreneurs establish illegal ventures that use new investors’ money to pay
returns to earlier investors (Valentine, 1998). In essence, they create an elaborate shell game that involves continually raising new funds, transferring recent investors’ money to earlier investors as their return on investment, and diverting substantial sums of money for the Ponzi entrepreneur’s personal use. An initial sample frame of hundreds was winnowed down and data were gathered on the 36 ventures that survived for ten years or longer. We used the legal cases, reports and news releases related to litigation surrounding these illegal ventures, newspaper and magazine articles, television news reports or news magazines and other sources of information on the ventures and their activities.

FINDINGS & IMPLICATIONS

Qualitative research is an iterative process demanding that researchers continuously build insights by exploring the data, going back to the theory, and then back to the data again (Strauss & Corbin, 1998). In this study, data were analyzed through multi-case analysis methods (Eisenhardt, 1989; O’Connor, Rice, Peters, & Veryzer, 2003; Yin, 1994) incorporating grounded theory methodology (Strauss & Corbin, 1998). All of the gathered data for each Ponzi scheme case was read by two members of the research team. The themes that emerged in our initial analysis surround how the entrepreneurs used isomorphic techniques to hide their deception while they were in plain sight of other stakeholders.

In addition to demonstrating how illegal entrepreneurs use mimetic, coercive, and normative isomorphism in their operations, we also extend current theory by developing the concept of subversive isomorphism. Below we discuss each of these findings.

The Isomorphic Actions of Illegal Entrepreneurs

New illegal ventures face substantial uncertainty associated with operating outside of the law and these ventures may benefit from mimicking successful legal entrepreneurial ventures and other successful firms in their industry. Survival for illegal entrepreneurs hinges in part on avoiding detection and establishing the legitimacy of their ventures. The more illegal ventures can achieve “taken for granted” status as organizations in an industry (Aldrich & Fiol, 1994), the greater their legitimacy. This means that more stakeholders view these illegal ventures as acceptable and legitimate new businesses in society, making it less likely that questions will be raised about their operations or that someone will report the organization to legal authorities.

We found that illegal entrepreneurs strategically manipulated institutional expectations to reduce uncertainty and create legitimacy by incorporating coercive, normative, and mimetic isomorphism techniques.

Coercive isomorphism refers to changing or conforming due to the pressures put on the organization to align with certain culture and societal expectations (DiMaggio and Powell 1983). Conforming helps legitimize the organization as it tends to go along even though much activity is only political or ceremonial (Meyer 1981; Ritti & Goldner 1979). The illegal entrepreneurs showed evidence of such isomorphism through the manner in which they dressed, their opulent office space, and the appearance of following government regulations.

Normative isomorphism, the following of professional norms and appearing as a member of a specific industry, was also present in our study. Craig Reinhard, who was eventually prosecuted for his Ponzi scheme, manufactured fictitious investment documents and financial statements in order to cover up his theft. In this case, Reinhard was showing the norms of the industry to clients
through the method of his work (DiMaggio & Powell 1983). Manipulating paperwork to show “the production of the producers” (Larson 1977) was a common occurrence as most entrepreneurs developed some form of manufactured promissory note or statement of account.

Mimetic isomorphism – the tendency for organizations to adopt forms similar to others – arises in part as organizations attempt to deal with uncertainty in their environments (DiMaggio & Powell, 1983). Often stemming from employee transfer or turnover, firms model themselves after other firms as employees imprint certain expectations from their old firm on the new firm. In the case of our illegal Ponzi entrepreneurs their knowledge of the industry allowed them to explain to perspective clients how the investment opportunity would work while also showing profits and returns that were not too far above what would be expected in the industry. In this way clients were happy to see a financial return that was above normal but in most ways the return was still consistent with the industry. For instance, David Connolly’s $50 million dollar real estate investment fraud promised clients 12% per year, similar to Allen Stanford’s $7 billion fraud that assured low double digits. Craig Reinhard told clients they could expect anywhere from 7-9%. The point here is that clients heard stories that were not too outlandish and instead modeled what they might see elsewhere.

Subversive Isomorphism

Through our primary analysis, the most prevalent finding across our sample is related to networks. The use of networks is one of the most important activities for entrepreneurs (Mosey & Wright 2007; Ozcan & Eisenhardt 2009) and in our sample we see that illegal entrepreneurs are no different. However, the means and ends to which they use their network uncovers new directions of the concepts of isomorphism.

Institutional theory holds that there are three mechanism for isomorphic change: “coercive isomorphism that stems from political influence and the problem of legitimacy; mimetic isomorphism resulting from standard responses to uncertainty; and normative isomorphism, associated with professionalization” (DiMaggio & Powell 1983). Our data and analysis (see Table 1) suggest that Ponzi entrepreneurs use their networks to conform while also making their ventures appear legitimate. This is the concept of subversive isomorphism.

Subversive isomorphism stems from the use of networks to overcome the general entrepreneurial starting condition of a lack of legitimacy and low resources. As we can see in Table 1, Stanford used his network of financial advisors, Cantens manipulated successful Cuban exiles and priests, and Waxenberg worked through a network of doctors, lawyers, and others. The illegal entrepreneurs in our study overcame their resource problems and legitimacy concerns by providing comfort and security in the mask of a trustworthy network. They subverted the system by giving false comfort. The investors who were duped felt comfortable in knowing others were involved; they felt secure in knowing (assuming?) that others had vetted the opportunity and were getting financial returns.

CONCLUSIONS

Within institutional theory, current forms of isomorphism speak only to the environment be it the firm (mimetic), the industry (normative), or the macro environment (coercive). Our study of illegal entrepreneurs extends theory by bringing forward the concept of subversive isomorphism:
abusing one's network to overcome the basic entrepreneurial condition of limited resources and low legitimacy.

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**Table 1 – Entrepreneur's Use of Network**

<table>
<thead>
<tr>
<th>Entrepreneurs</th>
<th>Ponzi Size</th>
<th>Network Used</th>
<th>Data Point</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allen Stanford</td>
<td>$8Bn</td>
<td>Stanford group used a network of financial advisors to sell approximately $8 billion of so-called &quot;certificates of deposit&quot; to investors by promising improbable and unsubstantiated high interest rates, supposedly earned through its unique investment strategy, which has purportedly allowed the bank to achieve double-digit returns on its investments over the past 15 years.</td>
<td>Allen Stanford SEC notice of order against 2 other defendants</td>
</tr>
<tr>
<td>Craig Reinhard</td>
<td>$3.9M</td>
<td>Fifty investors in several states cumulated to around $3.9 million. Reinhard marketed his scheme largely to elderly investors by offering to sell them FDIC insured CDs that provided returns that ranged from 7 to 9 percent. Many of the elderly investors were referred by friends or relatives who already had invested in IDPM &quot;CDs.</td>
<td>Clause 28, Pg 6, Craig H. Reinhard and Debra R. Bzik. pdf</td>
</tr>
<tr>
<td>David Connolly</td>
<td>$50M</td>
<td>The investors in investment vehicles were primarily individuals (residing through United States) and small Family Trusts. Connolly located prospective investors through various means. A number of investors were Connolly’s friends and family. Other investors were referred to Connolly by the network of the existing investors.</td>
<td>Clause 18, Pg 6, David M. Connolly.pdf</td>
</tr>
<tr>
<td>Edwin Yoshihiro Fujinaga</td>
<td>$813M</td>
<td>Public investors living in Japan, Canada, Malaysia and New Zealand. Hosted Japanese investors in Las Vegas for solicitation presentations and tour of MRI’s offices in Las Vegas. More than 8,000 investors having invested totally more than $813M.</td>
<td>Clause 11, Pg 4, Edwin Yoshihiro Fujinaga.pdf</td>
</tr>
<tr>
<td>Gaston Cantens</td>
<td>$135M</td>
<td>South Florida’s Cuban exile community. Eg. Jesuit priests and well-known leaders in the Cuban - American community in Florida Connected with own school - Belen Jesuit Preparatory School</td>
<td>Clause 17, Pg 5, Gaston Cantens SEC Case file.pdf</td>
</tr>
<tr>
<td>Howard Waxenberg</td>
<td>$70M</td>
<td>200 most wealthy investors from Los Angeles to Boston. Doctors, lawyers, accountants and retirees as part of the network.</td>
<td>Article on Waxenberg</td>
</tr>
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