



## A Growing Corporate Club: The Founding Felon

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In the courthouse parade of indicted and convicted business executives, Martha Stewart stands out as the most well-known member of a corporate club – the founding felon.

Like Stewart, some of the biggest names in the current wave of corporate criminal cases are company founders – Kenneth Lay of Enron, Bernie Ebbers of WorldCom, and John Rigas of Adelphia Communications. Steve Madden, founder of the shoe company that bears his name, is serving time, as is Sam Waksal, founder of Imclone Systems, the biotech company at the root of Stewart's recent conviction. Calisto Tanzi, founder of the now bankrupt Parmalat dairy company in Parma, Italy, is under investigation for a decade of alleged fraud.



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To be sure, hired managers such as former Tyco CEO Dennis Kozlowski, who is awaiting a retrial on fraud charges, and former investment banker Frank Quattrone, convicted in May of obstructing a federal investigation into stock allocation, have found themselves in trouble, too.

While most founders are never even summoned to court, they have a deep connection to their companies, making those firms especially vulnerable if their founders turn out to be felons, according to Wharton faculty and other experts. “What’s critically important for founders is their commitment to ethics at all levels,” says [Maurice Schweitzer](#), professor of operations and information management. “How do they fill out expense reports? Do they ask employees to [perform personal errands] for them? Do they misappropriate funds while throwing a lavish party for their spouse? That sends a signal to employees about the corporate culture and what is allowed.”

Since many founders spend the early years of their careers struggling to build their businesses, few have the kind of ethics training that is now a part of most professional managers’ corporate upbringing, Schweitzer points out. Companies, he suggests, should appoint a corporate ethics officer to help guide employees who find themselves in sticky ethical situations.

Ebbers, awaiting trial for accounting fraud, founded WorldCom in 1983 in Clinton, Miss., as a company that specialized in selling telephone service to motels. His aggressive acquisition strategy included his 1998 purchase of MCI. Lay, who has been indicted on securities and fraud charges, formed Enron in 1985 with the merger of Houston Natural Gas and InterNorth pipeline companies. By 2001 Enron was the seventh biggest U.S. firm in revenues, but later that year filed for bankruptcy court protection.

Founders who build a major company up from nothing often have a “blurred sense of boundaries,” says Schweitzer. Because start-ups usually require huge investments of both money and time, “there is no distinction between a founder’s personal life and company life. In some regard he or she is more likely to

use the company as a vehicle for personal desires,” he says. A wayward founder may also be more prone to bypass a company’s normal checks and balances. “Founders in some sense are given more leeway because everyone at the company owes their position to them.”

An additional consideration is that the founder “has often hired close friends in some very prominent positions,” Schweitzer says. These people, because of their relationship to the founder, exert so much influence that they are likely to get away with behavior that other executives might not.

Founders also tend to wield significant power through large financial stakes in their companies, more than hired managers can ever own even with lavish options packages. Stewart, for example, owns 61% of Martha Stewart Living Omnimedia. Because of this, “a founder would generally tend to have more power with the board,” notes Eleanor Bloxham, president of The Corporate Governance Alliance, a consulting firm in Westerville, Ohio.

### **The Entrepreneurial Commitment**

Founder-run firms generally outperform other companies in financial value, according to research by Wharton management professor [Raphael Amit](#) and Belen Villalonga, a professor at the Harvard Business School. Amit, who is also academic director of the Goergen Entrepreneurial Management Program, says it makes no difference whether the founder acts as chief executive or serves as chairman with an outside chief executive. “The founder is generally great for the company,” he suggests. “There is something about the entrepreneurial spirit, the commitment, the vision and the passion that carries over to the employees.”

In addition to performing better financially, Amit says family firms score higher on a corporate governance index developed, in part, by Wharton finance professor [Andrew Metrick](#). However, the research also shows that when a founder puts a family member in as chief executive, the effect on the value of the firm is negative, not just neutral.

“Whether the founder is CEO and chairman, or whether he or she is the chairman with a hired chief executive, it doesn’t matter. What does matter is when they serve as chairman with the son,” says Amit. In that mold, Adelphia founder John Rigas and his son Timothy were convicted of conspiracy, fraud and securities charges. Martin Grass, son of Rite-Aid founder Alex Grass, is serving an eight-year sentence after pleading guilty to charges of conspiracy to commit accounting fraud and obstruction of justice.

If the firm can survive a second generation and installs a third, it is no longer at a disadvantage, says Amit, who cautions that his observations are based on averages with significant deviations. He says the research, for example, did not examine the role of criminal convictions in the value of a firm. “To do any research project you need a fairly large data set ... With Adelphia and Enron, it starts building up.”

To prevent trouble, boards overseeing founding executives need to be extra vigilant, with a strong, independent board, compensation committee and audit committee, says Richard Steinberg, former leader of the corporate governance practice at PricewaterhouseCoopers who now runs his own consulting firm in Westport, Conn. “If there is an allegation of wrongdoing, the board must quickly launch an investigation and outside counsel typically is brought in to assist. In some cases the CEO can continue carrying out normal duties if there is added oversight.”

Once there is an indictment, though, the accused usually is asked to step down, Steinberg adds, noting that “this also points out the need for boards to focus on succession planning even where there is no expectation” of any problem.

### “Cookie of the Month”

For Martha Stewart, the personality and the product are so tightly interwoven that it will be difficult for the company to move forward, according to [Stephen J. Hoch](#), Wharton marketing professor. With time, Stewart potentially “might revert back to what she once was, but I doubt it. Even if nothing had happened, it’s not clear how sustainable her image was.” Ad revenue at Stewart’s flagship magazine dropped 54% in the first quarter, and the magazine has lost 500,000, or 22%, of its subscribers in the past 18 months. The publication will be redesigned to reduce the emphasis on Stewart's name; for example, the back page, where Stewart’s own essay once appeared, is now reserved for “Cookie of the Month.”

Hoch says many consumer companies are tempted to link their products to a personality to create swift brand recognition. “You live and die by the sword. It’s clear that relying on a personality is one effective way of solidifying a brand.” But companies that choose this strategy should be careful, he adds, noting that design houses typically try to wean customers off a specific personality while maintaining the brand. “With Polo, Ralph Lauren is still involved but the brand has its own personality. If the brand has staying power it takes on its own essence.”

Since Stewart’s sentencing – five months in jail and five months of house arrest – she has enjoyed an up tick in sympathy from the public, Hoch notes. Stewart, who was convicted of lying about selling stock in Imclone valued at \$230,000, is seen as a small transgressor compared to other executives who have been convicted of, or charged with, looting millions from their own companies. “There is sympathy for her, [a feeling] that the punishment is worse than the crime,” says Hoch. “But I don’t think the American public really needs Martha anymore. There are plenty of other people stepping up to be the taste master.”

Stewart, 62, has vowed “I’ll be back,” and is weighing whether to appeal her sentence. The appeal could delay punishment, but leave her company in limbo for as long as two years, legal analysts say. “Irrespective of what happens, her personality is past its prime,” suggests Hoch. “Maybe she can make a comeback, but I’m not sure whether she would see it as worth” the effort.

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