



## Corporate Fraud on Trial: What Have We Learned?

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The high-profile corporate scandals involving former WorldCom CEO Bernie Ebbers and former Tyco CEO Dennis Kozlowski are back in the news, refocusing attention on corporate fraud and inviting such questions as: What, if anything, has changed since these allegations emerged a few years back? And will the criminal trials of these two men, under way this week, serve as a deterrent to other high-profile executives who might be tempted to forget the rules of fair play in corporate America?



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Some observers caution that it's a little early to determine whether the most recent round of corporate reform efforts -- primarily the Sarbanes-Oxley Act, passed by Congress in 2002 and designed to increase corporate transparency and safeguards for investors -- will have much impact on America's executive suites and board rooms. Moreover, says Wharton legal studies professor [Thomas Donaldson](#), there are limits to the compliance approach to ethics. "Corporate governance is a hot topic, but we are overly optimistic about what corporate governance can do." Simply rearranging the chairs at the higher echelons of a company, he adds, will not prevent the types of fraud that have occurred over the past several years. Penn law school professor David Skeel agrees. "To the extent that we think we can head off the next round of scandals -- think that if we just get these cases right it won't happen again -- we're kidding ourselves."

### Cat-and-Mouse Games

Why the discouraging prognosis? A simple review of American history tells us that as long as there have been corporations, there have been corporate scandals. In his new book, *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From*, Skeel traces the history of modern day corruption by citing such examples as financial genius Jay Cooke, who masterminded a new strategy for selling government debt during the Civil War, and Samuel Insull, who built a vast utilities empire only to be ruined by the Depression and later decried by Franklin D. Roosevelt as a symbol of big business gone bad. In every scandal Skeel looked at, he found several common factors, including risk-taking and competition. Not surprisingly, these are the very aspects of business that regulators try to police. In the process, points out Skeel, we have set up an elaborate cat-and-mouse game that continues today.

Nobody doubts that government regulations are necessary, says Donaldson, but government is far from the action and "notoriously inept at knowing what's going on in detail inside the corporate decision-making mechanism." When testifying before the U.S. Senate during the Sarbanes-Oxley hearings, Donaldson reminded lawmakers that in all of the recent major corporate scandals, the companies in question had fairly elaborate corporate compliance programs in place. He warned that future government regulations would just be more of the same, noting that as regulations pile up, companies tend to get increasingly bogged down with technicalities. Executives end up spending very little time focusing on the bigger picture of simply what's right and wrong, or asking critical questions like, "What do we as a company value?"

For too long, says Donaldson, “we have followed a mythology that if you write an elaborate code of ethics, appoint people to distribute it, and get everybody to sign off on a fat rule book every year, this will somehow prevent major disasters. We have abundant evidence now that it simply doesn’t work this way.”

From the legal perspective, Skeel sees a similar trap. As the government pushes to try these cases in criminal, versus civil, court, corporate managers are going to do whatever they can to avoid trouble. While it may seem that the prospect of doing time would keep managers on the straight and narrow, it can also encourage a kind of slicing and dicing of the code to remain just barely on the right side of the law.

The Ebbers case is a good example. He is accused of fraud and conspiracy connected to the company’s \$11 billion accounting scandal. If found guilty, he faces up to 85 years in prison. The line between civil and criminal in securities law is quite fine, and often comes down to criminal intent, or willfulness, says Skeel. Ebbers is pleading the ignorance defense, leading Skeel to worry that if he wins, it will send a message to other CEOs and CFOs that a “don’t ask, don’t tell” policy is best. Indeed, Ebbers, who reportedly did not use email often, has not left much of a paper trail, leading prosecutors to rely heavily on the testimony of WorldCom’s former CFO, Scott Sullivan. On the other hand, in the 2004 trial of star technology banker Frank Quattrone, prosecutors won a conviction partly by relying on emails they said showed Quattrone deliberately obstructed a federal investigation.

Kozlowski, for his part, is charged, along with former CFO Mark Schwartz, with first-degree larceny, securities fraud and other related counts. The original case ended in a mistrial last April.

## Icarus and Other High Flyers

Corporate scandals are not unique to the U.S., but something about the American culture allows these scandals to happen more easily, says Skeel. “There is a fascination with risk-taking, and I think it’s related to greed. Or at least the two go together.” In his book, Skeel turns to Greek mythology and the story of Icarus to illustrate an important aspect of current and historical corporate scandals. Icarus, while enjoying his newfound freedom, ignores his father’s warnings and flies too close to the sun, finally melting his wings and dropping into the sea.

It is a cautionary tale, Skeel suggests. American entrepreneurship is based on an individual’s ability to strap on wings and jump off a cliff. But people who are willing to take that kind of risk are also the same people who refuse to heed warning signs of danger ahead. “An executive who takes excessive or fraudulent risks with a large corporation may jeopardize the financial lives of thousands of employees, investors, and suppliers of the business,” Skeel writes. Given that nearly half of all Americans now own stock, this kind of risk-taking behavior affects more people than ever before.

In other countries, either cultural norms or restrictions on competition work to keep these tendencies at bay, Skeel says. In Japan, for example, scandals are usually caused by mid-level managers rather than top-level executives, yet the typical response is that even though the CEO didn’t participate in the fraud, he resigns. The idea is that “this happened on your watch. You are responsible for it and the honorable thing to do is to resign,” says Skeel, adding that such a scenario is “completely different than what we see in the U.S. Here it’s usually the people at the top who are taking the risks, and the instinct is not to resign, but to keep fighting.”

In Europe, a strong culture of socialism tends to keep business leaders in check. When Jean-Marie Messier, the former CEO of Vivendi Universal, joined the “big leagues,” moving to New York and purchasing a multi-million dollar apartment, the French by and large were horrified, not so much because he joined the “other side” but because of his blatant flaunting of riches. When he eventually crashed and burned, the French tendency to believe that greed will get you nowhere was confirmed.

Also, says Skeel, tight regulation and concentrated economic power, typical in Europe, are further stop-gap measures against corporate scandal. “We rightly pride ourselves on the competitiveness of the American markets,” writes Skeel, “but competition increases the odds of spectacular corporate failures.” An interesting question to ask is: “Will we be seeing more American-style scandals in Europe, or are those cultural constraints strong enough such that the Parmalats and the Vivendis will prove the exception rather than the rule?”

### Recipe for Disaster

Perhaps it’s simply too difficult to legislate a general sense of morality. Newly enacted reforms, such as separating the role of chairman from that of CEO as a way of discouraging certain kinds of conflict of interest, are positive, says Donaldson, but they would not have prevented the Enron case. He would like to see greater emphasis placed on certain aspects normally outside the scope of corporate governance. For example, the culture within a corporation is critically important, he says. “Take companies like Johnson & Johnson or Goldman Sachs, which for decades have prided themselves on their integrity. It’s in the atmosphere, and people breathe it in when they work there.” He also believes that reward systems need to be carefully structured and monitored. For example, a middle manager rewarded only for hitting his or her numbers is a recipe for disaster, he warns.

Donaldson is guardedly optimistic about some of the newer compliance measures, many of which were enacted in November 2004 and focus on getting boards of directors and top management fully involved in the kinds of activities that can create problems. “We still have guidelines, but instead of assigning them to an ethics officer or chief legal counsel, the very people who run the organization have to be trained in ethics and compliance, and they must devote time at meetings to assess risks and develop channels of information,” says Donaldson. “These are the kinds of measures that will greatly diminish the possibility of another Enron or WorldCom.”

Wharton legal studies professor [Thomas W. Dunfee](#), who has taught business ethics since the 1970s, points to the role of education in the context of these scandals. He believes that they make a strong case for teaching ethics to business students, both undergraduate and MBA. “In many of the classic [corporate scandal] cases, it’s clear that managers didn’t see their actions in the context of ethics,” he says. But by looking at the failures of others, students and business executives can map out categories of problems and potential strategies for dealing with them. Transparency in business is an important lesson Dunfee passes on to his students. “I like to tell them, ‘If you are writing a memo, imagine that you are cc’ing the Department of Justice.’”

The “big truth,” says Donaldson, “is that there is only so much we can gain from corporate compliance programs and corporate governance.” Or, as Skeel puts it: “The devious behavior of men and women knows no bounds.”

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