

The Seven Signs of Ethical Collapse: How To Spot Moral Meltdowns in Companies . . . Before It's Too Late

A Focus on Ethical Culture

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Companies That Fell; Round 2 for some

- **Adelphia**
- **Boeing**
- **Cendant**
- **Computer Associates**
- **Tyco International**
- **General Electric**
- **Global Crossing**
- **Merrill Lynch**
- **Enron**
- **Qwest**
- **WorldCom**
- **Royal Shell**
- **Nortel**
- **Krispy Kreme**
- **Refco**
- **Hewlett-Packard**
- **UnitedHealth Group**
- **AT&T**
- **Xerox**
- **Kmart**
- **Citigroup**
- **Lucent**
- **ImClone**
- **Arthur Andersen**
- **HealthSouth**
- **Royal Ahold**
- **Parmalat**
- **Apollo Group**
- **Marsh & McLennan**
- **AIG (Putnam)(Mercer)**
- **Fannie Mae**
- **KPMG**
- **GM**
- **The stock options (140 companies)**

Some sample fines . . .

- St. Barnabas (outlier issues)
 - \$265 million fine
- AIG
 - \$1.5 billion for accounting misstatements
- HealthSouth
 - \$1 billion restatement
 - \$100 million fine
- Tenet
 - \$725 million settlement
 - Plus interest, for total of \$900 million
- HCA
 - \$1.7 billion in civil and criminal fines
- UnitedHealth Group

I. What can we learn?

a. These were not close calls.

- Capitalizing ordinary expenses
- Backdating options
- Embezzlement
- Insider trading
- Fraud
- Spying

b. We've been down this road before.

"Where were these professionals ... when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions?"

Judge Stanley Sporkin

Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, at 920 (D.C.Cir.1990).

So, what makes good people at great companies do really dumb and unethical things?

Knowing business history and that these were not close calls, how do these ethical, legal, and, too often, financial collapses occur?

II. Thoughts on common threads among the collapsed companies and antidotes for prevention

The Seven Signs of Ethical Collapse

**How to Spot Moral Meltdowns in Companies...
Before It's Too Late**



Marianne Jennings, J.D.

Common Traits in Ethical Collapse

1. Pressure to maintain numbers
2. Fear and silence
3. Young 'uns and a Bigger-Than-Life-CEO
4. Weak board
5. Conflicts
6. Innovation like no other company
7. Goodness in some areas atones for evil in others

1. Pressure to Maintain Numbers

- High ROE; double-digit growth, etc.
- Pledges to continue the performance

Pressure Antidotes

- Antidote: Help employees distinguish between superior skill, foresight and industry and cheating.
- Antidote: Watch unconsciously sent signals.
 - “Find a way.”
 - “Whatever it takes.”
 - “Sharpen your pencil.”

2. Fear and Silence

- There is *never* a problem with employees missing the ethical issues
- Always a problem of not raising the issue, being ignored, not having an avenue for raising the issue, or being fired for raising the issue

David W. Delainey, former head of Enron Energy Services

“That was the worst conduct I had ever been a part of and everybody knew exactly what was going on at that meeting.” [\[1\]](#)

[\[1\]](#) Alexei Barrionuevo, “Ex-Enron Official Insists Chief Knew He Was Lying,” *New York Times*, March 2, 2006, p. C3.

Hewlett-Packard

“How does Ron [Ron DeLia, Boston PI] get cell and home phone records? Is it all above board?”

H-P senior counsel and ethics officer, Kevin Hunsaker

“We are comfortable there are no Federal [sic] laws prohibiting the practice.”

Anthony Gentilucci, H-P global security officer

“I shouldn’t have asked.”

Hunsaker in response

Ethics at Work

KPMG 2000 Survey

- 76% of employees observed a high level of illegal or unethical conduct at work in the past 12 months
- 49% of employees observed misconduct that, if revealed, would cause their firms to “significantly lose public trust”

KPMG 2005 Survey

- 74% of employees observed a high level of illegal or unethical conduct at work in the past 12 months
- 50% of employees observed misconduct that, if revealed, would cause their firms to “significantly lose public trust”

State of Ethics

- 65% DIDN'T REPORT (1999)
- 37% DIDN'T REPORT (2003)
- 41%-50% DIDN'T REPORT (2005)
- 50% DIDN'T REPORT (2006)

Why didn't they report?

- 96% feared being accused of not being a team player (same 1999, 2003)
- 81% feared corrective action would not be taken (2005 data leaning toward this as #1)
- 68% feared retribution from their supervisors
- 57% feel pressure to do “whatever it takes” to meet business targets
- 49% believe they are rewarded for results, not the means by which they achieve them

(SHRM and industry surveys)

KPMG Internal Culture During Tax Shelter Years

- \$1.2 billion of the firm's \$3.2 billion in annual revenue
- Mandatory weekly conference calls for 500 tax partners
- *“You're either on the team or off the team.”*
Jeffrey M. Stein, head of KPMG Tax Department to senior manager who raised concerns about tax shelters during a call

Fear and Silence Antidotes

- Anonymous reporting
- Response and follow-up
- Review by board
- Disciplinary actions
- Reward system (guidelines now have both carrot and stick requirements)

Remember two critical elements:

1. Tone at the top and the importance of example
2. Enforcement: Must be absolute, unequivocal, egalitarian

3. Young 'Uns and Bigger-than-Life CEO

- CEO a full generation older than direct reports and/or lack of depth in direct reports
- MBAs (senior management)
- “I hire them just like me: smart, poor and wants to be rich.”

Dennis Kozlowski

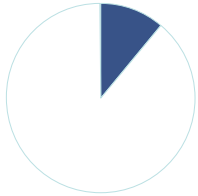
Former CEO, Tyco

A Look At Your Future Work Force

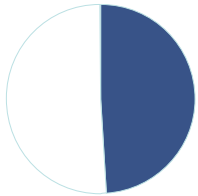
- 60% of high school students cheated on an exam in the last year
- 62% of high school students lied to a teacher in the past year
- 82% of high school students lied to their parents in the past year
- 33% copied something from the Internet
- 28% stole from a store in the past year
- 23% stole from a parent or relative

Josephson Institute 2006

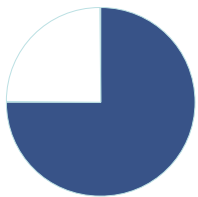
Cheating in College



11% reported cheating in 1963



49% reported cheating in 1993



75% reported cheating in
2003/2005

Iconic CEO and Young 'uns

Antidotes

- Always question the icon
- Help the young 'uns: ethics requires daily effort, reinforcement, and training
- Without it, you slip – Everyone believes they are ethical!
- Introspection is the key

High Ethical Self-Esteem

Living in Denial and Slipping Into
Complacency

We all think we are ethical.

- None thought their ethical standards were lower than those of their peers in their organization (1%)

Society of Human Resource Managers

Self-Esteem Data: We all think we're ethical

- 74% say their ethics are higher than those of their peers
- 98% say it is important to them to be a person of good character
- 83% said that at least one-half of the people who know them would list them as one of the most ethical people they know
- 92% are satisfied with their ethics and character

Even the 75% who say they have cheated!

Guess who said it?

"Ethical standards and practices in the workplace are the pillars of successful employment and ultimately the benchmark for a strong business."

Guess who said it!

“I have the highest ethical standards.”

Guess Who Said It!

“Embezzlement cannot be condoned in any manner. [n]ot only did he steal from the stockholders . . . But he breached the fiduciary duty placed in him. Wrongdoing of this nature against society is considered a grave matter. . . . [h]e should receive the maximum sentence.”

4. Weak Boards

- Experience
- Age
- Conflicts
 - A. Consulting
 - **B.** Related parties transactions/interests
 - C. Philanthropy
 - D. Complexity of relationships

Weak Board Antidotes

- Dig deep on conflicts
- Don't fall for governance myths:
 - Stock ownership
 - 10-year limits
 - Mandatory retirement
 - Nomination by shareholders
- Challenge officers, but don't micromanage
- Pay attention to perks
- Know industry accounting issues
- MBWA

5. Culture of Conflicts

ACTIVITY	PERCENTAGE OF COMPANIES
Purchases or sales of insiders' products or services	47%
Loans to executives	39%
Directors who sell legal or banking services to company	35%
Buying, selling, lending to or investing in companies insiders own	21%
Hiring relatives	14%
Director consulting arrangements	11%
Leasing, selling or buying airplanes to or from insiders	10%
Company borrowing from insider or insider's company	6%

SEC Report 2003

Conflicts Culture Antidotes

- Believe in conflicts of interest!
- Remember the two ways to manage a conflict:
 - Don't
 - Disclose
- Establish definitive rules and follow them.

6. Innovation like no other

Guess who said it!

“ . . . standard accounting rules [are] not the best way to measure [CA’s] results because it had changed to a new business model offering its clients more flexibility.”

A Few Quiz Questions

What company was described in 2001 as having a delivery and marketing model that would change its industry?

A belief that mundane rules don't apply to them!

- Dot-com mantra of EBITDA, “You know, if we hadn't had all those expenses, we would have had earnings!”

7. Goodness in some areas atones for evil in others

- Culture of philanthropy
- Culture of diversity
- Culture of safety
- Culture of environmentally conscious operations
- Culture of volunteerism
- “The Changing Lanes” Phenomenon of Moral Schizophrenia

Antidotes for the Good/Evil Balancing Act

- Rethink popular notions of social responsibility and business
- Rethink company activities, perceptions, realities
- Be very skeptical about “doing well by doing good”
- Rely on virtue ethics and simplicity: Truth, Honesty, Fairness, Egalitarianism

Enforcement is Absolute, Unequivocal, and Egalitarian

- *“If the janitor had taken the liquor, he would have been fired.”*

Student’s observation on discussion of tolerance for a manager who “borrowed” three bottles of vodka on a Friday night for her birthday party after work and brought in replacements on Monday morning

III. Thoughts on Overarching Philosophy and Attitudes

a. Watch the gradual slippage that comes from complacency.

On Slipping . . .

“You slip-slide into evil, he thought. You cross the line for just one moment. You cross back. You feel safe. You change things, you believe, for the better. The line is still intact. Okay, maybe there’s a smudge there now, but you can still see it clearly. And the next time you cross, maybe that line smudges a little more. But you have your bearings. No matter what happens to that line, you remember where it is. Don’t you?”

Harlan Coben, Chapter 32

b. “We don’t think they began as frauds.”

- The problem of “A Simple Plan”
- “Time-out” Antidote
- “It’s a gray area.”

Questions About the Gray Area?

- Why is it important that it be gray to you?
- Is it legally gray?
- Is it ethically gray?
- Is it a good-faith disagreement?
- Interpretation vs. loophole vs. nondisclosure of relevant information
- Descriptors: “Aggressive opinion”
“Aggressive accounting”
“Financial engineering”

c. Ultimately, leadership and example matter.

Culture is to company what character is to individual.

Culture comes from the collective actions and responses of leaders.

Ultimately, culture depends on individuals' character.

The Missed Reassurance of the HP Crisis.

Layers of Responsibility for Ethics

Who is responsible?

