THE Seven Signs of Ethical Collapse

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

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Author's Note

Both guilty. Today as this book goes to press, Ken Lay was found guilty of all six charges of conspiracy and fraud, and Jeffrey Skilling was convicted of nineteen of twenty-eight charges of conspiracy, fraud, false statements, and insider trading. Mr. Lay was also found guilty on all four charges of bank fraud and false statements in a separate bench trial. The convictions covered everything from misrepresentations to auditors to falsehoods in discussions with analysts. In other words, the factual bases for the charges consisted of behavior that occurred while they were doing the day-to-day activities of CEOs. Both men now face maximum sentences at levels I cannot compute without the aid of a calculator.

Their own testimony was perhaps their undoing. Hubris, as this book discusses, is the stuff that comes before a fall. Skilling and Lay, like so many executives who reach stellar performance levels for their companies and experience the resulting iconic status, honestly believe that they can pull a rabbit out of a hat and defy reality and truth to save themselves. Mr. Lay was a piece of work on the witness stand. He even took his own lawyer to task in front of the jury! This classic and dangerous imperial CEO could not be persuaded to, just this once, listen to someone else's advice. Mr. Lay went so far as to allege that it was that diabolical band of socialists at *The Wall Street Journal* who brought down his otherwise thriving company. Even Oliver Stone got a chuckle out of that one from his perch on a nearby grassy knoll. Mr. Skilling was better on the stand but still showed a profound detachment from ethical reality. He didn't think that investing in an ex-girlfriend's company that just happened to do business with Enron was a big deal. Conflict? What conflict?

Mr. Skilling had a tin ear on perception and a blind eye for writing on the wall. When Daniel Petrocelli, Mr. Skilling's lawyer for the trial, first met with Mr. Skilling to discuss serving as his defense lawyer, Mr. Petrocelli owned to him that he was not a criminal lawyer. Mr. Skilling's response was, "That's okay. I'm not a criminal." Wrong again, this time wrong for a lifetime.

These verdicts, coupled with the convictions of Bernie Ebbers, former CEO of WorldCom, Dennis Kozlowski, former CEO of Tyco, and John Rigas, former CEO of Adelphia, surely put the fear into executives. Dear executives, have no fear. Do something to be sure that you do not become one of these bright and capable but detached-from-reality CEOs.

To me, the news of the Skilling and Lay guilty verdicts is not as important as some other business news. Even as their trial progressed, UnitedHealth Group announced the following: (1) It was conducting an internal investigation from 1994 forward on its stock options awards; (2) its earnings might have to be restated because of questions related to its accounting for those options; (3) the SEC had launched an informal investigation into the stock options issues; (4) it had received a subpoena from the U.S. attorney for the Southern District of New York related to its stock options during the period from 1999 forward; and (5) it had received a request from the IRS for information on its stock options from 2003 forward. That's just one company!

Here we are nearly five years out from Enron's fall and four years from Sarbanes-Oxley's mandates on financial reporting and the same business ethical missteps keep cropping up. Franklin Raines, the former CEO of Fannie Mae, testified in favor of Sarbanes-Oxley but was ousted as its CEO two years later even as the company made a $1.1 billion financial restatement. Nearly every day another company's pension woes or some other accounting issue bring more ethical (and sometimes legal) lapses that are inevitably followed by financial bad news. Heck, even the lawyers are now being indicted for kickbacks.

How can we be this far out from the huge scandals with so many convictions and still experience almost daily, as Yogi Berra would say, déjà vu all over again? Did these post-Enron problem companies and their leaders not take the lessons to heart? Did they fancy themselves different from Enron? Did they think they were immune from the rules? It's worse than we realize. I can take you back through decades and show you that the anatomy and activities of scandalous companies are all alike. The reason we are still at it is because the factors that lead to ethical collapse are still with us. The failure to recognize them and put antidotes in place ensures that the scandals will continue. The Skilling and Lay guilty verdicts sober us and give us pause. But do we fancy ourselves different from these companies and the now-convicts who led them, or do we work to be sure we don't fall into the same traps? We need some new ideas and a different road. Herein, the tools for the journey to propriety and ethics. Appropriately, and with great reassurance, the path for our journey is far, far away from criminal convictions.

—Marianne Jennings, May 25, 2006

Preface

"How could you not see this coming?" That's my standard response when another industry giant falls into ethical collapse. But the answer to my repetitive question is not obvious or simple. Not everyone has connected the dots on the patterns in ethical collapse. Ethical collapse is a state of moral malaise. Ethical collapse happens when organizations are unable to see that bright line between right and wrong. Or perhaps those within the organization see that bright line, but the culture is so fearful, wild, or obsessed with numbers and goals that no one wants to hear about the bright line anymore. Some organizations pull themselves back from ethical collapse. Others continue right on into legal and financial collapse. While most people are enamored of continuous double-digit growth in earnings, I have always seen it as a warning sign. While most people feel terrific when the CEO of the company in which they own stock becomes an iconic media darling, I worry. And while most people see corporate philanthropy as evidence of an ethical commitment, I know different. Not every philanthropist is headed toward ethical collapse. But not every philanthropist is ethical. They couldn't see the ethical, and possibly financial, collapse coming because the traditional tools used for evaluating companies and their potential are too rote, mechanical, and numerical. The tests for company viability and financial performance are too facile. A good analysis of where a company is headed demands a look at qualitative factors, those touchy-feely, squishy, from-the-gut factors that are ignored despite the fact that they often determine the company's fate. In my views on companies and their future, I follow Jeffersonian wisdom: "In matters of style, swim with the current; in matters of principle, stand like a rock." There has been too much falling for style and too little substantive analysis. Principle dictates digging a little deeper to find the soul and potential of a company—and too often these days, the lack thereof.

I had seen what I suspected was a pattern in companies that collapse because of ethical issues and the resulting legal problems in the savings and loan debacles and also during the Boesky and Milken junk-bond era. But when we hit the dot-coms turning into dot-bombs and rolled right on into Enron, Adelphia, WorldCom, HealthSouth, and more recently Nortel, Fannie Mae, and—Refco, and, well, this time the list is too long to catch them all—I knew I had found something. The third time is the charm, and I concluded that it was time to share the evaluation tools I have been using to determine the ethical culture of companies. That ethical culture, its absence or its presence, controls all the other quantitative factors. In early 2005 I listened to Abby Joseph Cohen, one of Wall Street's top analysts, explain how those in her profession could have been so wrong in their evaluations from 1999 to 2003. Her explanation was that the companies gave analysts incorrect numbers. Don't blame it on us, she proffered, because the analysts were also victims of these gargantuan frauds. My response was "How could you not know that the numbers were incorrect?" Yet she was not alone in that thinking. Everyone relied on company numbers. But assuming that the numbers are correct ignores critical issues in qualitative analyses of companies, issues that can influence the numbers as well as the eventual fate of those companies. With the best of the best overlooking these key qualitative factors in analysis, I realized that my seven signs of ethical collapse might help.

The question "What are the seven signs?" is compelling, but another question stares us boldly in the face: "What the heck is ethical collapse?" Ethical collapse does not mean an organization joins the ranks of Enron, WorldCom, Adelphia, the Baptist Foundation of Arizona, or Arthur Andersen in financial collapse. Indeed, the whole purpose of this undertaking is to bring ethically troubled company souls back from the brink before that occurs. Ethical collapse occurs when any organization has drifted from the basic principles of right and wrong. Some drift in the area of financial reporting standards and accounting rules. Others drift with safety issues surrounding their products. In government many drift when it comes to working with and accepting gifts from lobbyists. Not all the companies that drift ethically have violated any laws. There are many pleas, settlements, and agreements that companies discussed and studied in these pages have reached for the sake of expediency and/or not because of any legal violations. The majority of the reports on settlements indicate that the company involved does not admit any wrongdoing. Indeed, I would be the first to state unequivocally that hung juries and acquittals in these cases are reassurance that the jury system works. The "common man," when presented with the tasks of finding intent and guilt beyond a reasonable doubt, cannot always conclude that either was present in the complex transactions that often do carry the protection of technical compliance with the law. However, the law was never intended to be the maximum for standards of behavior. The law represents the minimum standard of behavior required. We are permitted to do more than the law requires and less than the law allows. A company can be teetering ethically without crossing legal lines.

When an organization collapses ethically, it means that those in the organization have drifted into rationalizations and legalisms, and all for the purpose of getting the results they want and need at almost any cost. This drift into "Everybody does this" and "It's not a question of 'Should we do it?' it's 'Can we do it legally?' " mentality occurs because of the combination of the seven factors working together to cloud judgment. False impressions or even concealment seem to offer perfect candor to those ethically collapsed organizations. Indeed, their conduct may be perfectly legal, but that standard is one of the problems in ethically collapsed organizations. They meet legal standards without really considering the long-term implications of technicalities, taking advantage of loopholes, and the resulting impact on the individual and organizational soul. They are concentrating so much on the "Gotcha strategy" of finding the loophole or the easier way around the tough slog of diligent competition that they are no longer managing as effectively, creatively, or successfully as they could.

It's the complacency that kills companies and individuals. We all drift in the day-to-day pressures and decisions. The key is pulling back, putting checks and balances on the complacency, and recognizing parallels between the decisions and practices you have chosen that, while legal, look very much like the beginnings of a dangerous journey. When we buy a new car we are attuned to its pristine feel and smell. We are also keenly aware of its cost. The result is that we only allow bottled water as our sole means of auto refreshment. The months go by and we let our absolute standard down and move into the brown beverages. By the end of the first year, food has crept into the refreshment standard. If we don't pull back, ketchup, Hawaiian Punch, hot fudge, and all manner of permanent-stain food become regulars in our auto life. The purpose in understanding ethical collapse is to pull back before we get to Hawaiian Punch, to catch ourselves before there is permanent damage to company and career. Companies in ethical collapse or headed toward ethical collapse always have the option of reform, of going back to the heightened sensitivity of the pristine conditions they once had in their autos. To avoid the permanent consequences of ethical collapse, we have to once again sensitize our desensitized selves and companies to those bright lines between right and wrong that have gradually eroded. Managers in companies in ethical collapse have lost the ability to stop and take a hard look at whether their practices are in the best long-term interest of themselves and their shareholders. If they can take the route of painful introspection and its demand for changes, they may be able to turn things around. If they can't see the damage they are doing with their shortcuts, they will find trouble lies ahead. If they can change and reinvigorate their ethical cultures, they can go forward with strategic moves grounded in solid business principles, not slippery gotchas.

Since the passage of Sarbanes-Oxley, there is reason to hope that the introspection is happening. Companies are pausing for a "Wait a minute!" They are looking at their numbers, their products, their marketing practices, and asking, "While this may be legal, is it really ethical? Are we following the spirit of the law here?" The number of earnings restatements set a record in 2005—slightly more than 1,200—but the number of investor lawsuits against companies is down, with only five cases filed in 2005. What we have with this attention to numbers is evidence of companies taking that difficult and introspective look at their own accounting and financial reporting and making better decisions. To use a Seinfeldism, "Not that there was anything wrong with that," the companies are taking the accounting high road on many issues to avoid the consequences of flying too close to the treetops. Many of the earnings restatements by companies are over issues upon which those within the company, and even outside experts, disagree. That these issues percolated into the public eye and were raised within these companies when there was plenty of the so-called and infamous "gray area" in many of these restatements is a tip of the hat to the checks and balances, presented in Chapters 2 through 8, to prevent, curb, or come back from ethical collapse.

A simple illustration and challenge I give to my students provides a micro look at what ethical collapse is and what it does. I caution my students about the use of "stuff" to win friends, contracts, and influence. "Stuff" consists of lunches, dinners, rounds of golf, cookie platters, golf clubs, tickets, a place in a private box at a concert or sports event. Stuff is everywhere in the business world and, I am assured, absolutely necessary for the so-called "face time" with those with whom you are trying to curry favor. Stuff always starts small and continues to grow until we are all in there slugging with more and more stuff until we turn into a Jack Abramoff. When we look back at the stuff that was generously bestowed, we find it all very embarrassing, to giver and givee. We read about this embarrassment of increasing stuff and wonder, What was *he* thinking? Worse, we look at all the stuff and realize that despite our best hopes and pride in gifting stuff, the impact and results from stuff were marginal. Ethical collapse in this micro example of stuff occurs when we can no longer evaluate objectively whether the stuff is necessary, whether it is effective, and whether we have crossed some lines in our use of it.

In organizations, ethical collapse occurs when they can no longer evaluate their position, conduct, goals, numbers, and performance with an objective eye. They may not have crossed any legal lines but they have lost their edge because they cannot see the risks in their choices, conduct, and strategies. What the rest of the world will look at as pushing the envelope makes ethically collapsed organizations issue a type of George Costanza (of *Seinfeld*) response, "What? You mean there's something wrong with this?" This Costanza syndrome is a one-sentence summary of ethical collapse. There is a problem, or two or more, but those inside the organizations either do not see it or would prefer to continue along a path that will prove to be damaging, if not destructive. The seven signs are here to head these organizations off at the path to damage and destruction.

My hope is that by using these seven tools, analysts will be able to look more deeply at those who furnish the numbers and thereby be able to detect when those numbers seem suspicious or should be subjected to greater scrutiny. These seven factors detect risk for numbers being wrong. I also hope that investors can spot failing cultures, that regulators can stop the train wrecks of fraud, and that every other type of organization, from government agency to nonprofit, can benefit from the organizational lessons that are universally applicable. An ethical culture nurtures growth and success. An ethically risky culture harms investors in public companies.

However, ethically risky cultures are everywhere, alive even in government agencies and nonprofits. When these nonbusiness organizations collapse, there is enormous fallout, in everything from the breach of public trust to the loss of support for noble causes. A poor ethical culture breeds ethical breaches. Ethical breaches then often lead to legal violations. Too often accompanying both is financial collapse. NASA had its ethical and cultural issues, and the results were the deadly accidents involving the space shuttles in 1986 and again in 2003 and the embarrassing debacle of the nonfunctioning Hubble telescope. Ethical collapse permitted the sexual-abuse scandals of the Catholic Church to parboil for decades. When the truth finally percolated to the surface, the fallout for the Church was financial and ecclesiastical. In the United States, payouts to victims of sexual abuse by priests was $1 billion as of June 2006. The criminal prosecution of priests and the daily press coverage found members and nonmembers alike wondering, "How could it have gone this far? Why did no one see this happening or take action?" The United Way experienced years of declining donations and great dissent following the wild ride of William Aramony's tenure as its free-spending CEO. That sore spot still surfaces as the United Way recovers its reputation from the damage of ethical collapse.

With each company, agency, and nonprofit collapse, we look at the long ride there and wonder how those involved could not have seen it coming. We learn of the transfers of employees, even priests, so that the truth did not emerge. We note the pacts of silence among employees and others. The pattern is the same, but we missed seeing all the crises coming because we did not yet understand the pattern or have the skills for spotting the evolving signs of ethical collapse. Now, having the rich experience of reviewing such collapse across decades and all forms of organizations, we have the pattern.

More important, and happily, we also have the antidotes for ethical collapse. This book is not just a forecasting tool for investors and analysts. This is a book written to provide prevention tools for all types of organizations. For every sign of ethical collapse, there are antidotes, checks and balances that can be put into place to thwart the march to the ethical cliff.

It's a tall order to take over twenty years of research, observations, and work and plunk them into three hundred or so pages. I continue to be grateful to my agent, Greg Dinkin, and his partner, Frank Scatoni. They have believed in me and my work since the time Greg was a student in my MBA class. He urged me to put my work into a book so that others could benefit. I am grateful to both of them for their ethics in everything from negotiations with publishers to advice on content, direction, and decisions. In a competitive and cutthroat business, they have eloquent and ethical restraint.

My students are in this book because with each case study they have offered insights and refinements on my theories of ethical collapse. They continue to teach me as they write to me with more examples and illustrations of ethical collapse. "You probably already saw this but . . ." is the way their e-mails to me begin. More often than not I have missed the information they are sending along, and I am grateful for their keen eyes and powers of observation. I am honored that they have remembered what they learned.

I am grateful for the wisdom of my parents, whose solid advice of "if it sounds too good to be true, it is too good to be true" led me to this exploration of ethical collapse. The seven signs of ethical collapse represent more details on this notion of "too good to be true," their general theory on investments and life.

I owe my husband and children for their sacrifice of time and for their help as I write and research. I owe them for grounding me. Their presence and needs allow me the daily opportunity to step back from work and ponder. In that reflection, those times of Little League games and carpools, my best insights come. Without them I would not have the luxury of reflection that comes only when the mind is distracted. If *A Beautiful Mind* is an accurate portrayal, game theory was born because scientists were trying to pick up girls in a bar. *The Seven Signs of Ethical Collapse* took flight because I was at one of my children's Little League games and a four-foot, eight-inch batter didn't have the legs to steal second. He was out, in a series of events that was not even a close call for the ump. His team lost the game. The season was over and done. The short-legged batter should have stuck with solid hits and sprint training. Stealing was not the secret to success. So it is with companies that try unethical shortcuts to success. They may get ahead in the game for a while, but they collapse. In finding the signs of ethical collapse, I also found the antidotes; and all of this arrived courtesy of a Little League season for the B players and unsuccessful base snatchers. That kind of inspiration and insight doesn't come without serendipity. Thank you, dear family, for all your interruptions. Without them and you, life would be dull and my work devoid of serendipitous inspiration.

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CHAPTER ONE

What Are the Seven Signs? Where Did They Come From? Why Should Anyone Care?

Predicting rain doesn't count; building arks does.

—Warren Buffett, from his 2001 letter to Berkshire Hathaway shareholders

It was just after the collapse of Lincoln Savings and Loan and Charles Keating's criminal trial that I began to notice a pattern. Tolstoy wrote that all happy families are alike and all unhappy families are unhappy in their own ways. The inverse appears to be true when it comes to ethics in organizations. All unethical organizations are alike; their cultures are identical, and their collapses become predictable. More than once I have been interrupted with a correction as I have told the story of General Motors, its redesign of the Malibu, and the memo from the young engineer who expressed concern that the car's gas tank was too close to the rear bumper and not insulated sufficiently in the event of rear-end collisions.

As I explain the young engineer's fears that the cars would explode too readily and upon the slightest rear-end impact, someone usually raises a hand and says, "Excuse me, but don't you mean Ford and the Pinto?" I gracefully assure them that I am aware of the Ford Pinto case and how its gas tank was also positioned too close to the rear bumper, but that I really do mean GM and its Malibu. History repeats itself when it comes to ethical lapses and collapses.

The pattern is the same. Pressure to design a new car and get it out on the market to meet the competition. A flaw in the design. A young engineer who sees the flaw. A supervisor who doesn't want bad news. A management team counting on no bad news. A shortsighted decision to skip the expense of the fix to the flawed design. Then the cars are in flames, the lawsuits begin, and those involved have the nerve to act surprised that all this is happening to them. The Malibu and Pinto stories include ethical-culture issues that are common to companies that endeavor to postpone or hide the truth about their products. As the problems with the gas tanks and explosions in the Ford Crown Victoria police cars (the Crown Vics, as they are called) emerge, the same story is likely to be repeated in the company that brought us the Pinto thirty-five years ago. You could substitute Johns-Manville and asbestos, Merck and Vioxx, or any other product-liability case and find a similar pattern. New-product problem arises, employee spots the issue, company hides the problem, press releases equivocate, and officers postpone public disclosure as they try to control the truth about that problem and continue to hope for the best. The strategy never works, but these companies have created a culture destined to follow this failing strategy.

Almost daily there is a breaking story about another company or individual who has fallen off the ethical cliff. In 2006 Nortel had to postpone the release of its 2005 earnings because of questions about its accounting that arose while it was still in the process of restating its earnings for 2001 through 2004. In 2005 the company announced earnings restatements for 2004, which followed a 2004 announcement of earnings restatements for 2003 that would cut half of the company's \$732 million in profits. For those of you still keeping score, that's three restatements in three years. As one analyst noted, these kinds of accounting issues make it difficult for investors to trust the company. Further, the fallout for employees and company size is significant. A company that had 95,000 workers in 2001 will have 30,000 workers once it completes its latest 10 percent downsizing. Somewhere during the humiliation of the restatement activity there must have been one or two employees who thought that perhaps correcting the problems of the past required that they not be making the same mistakes presently.

In this Nortel story and so many others about companies and executives, we find ourselves shaking our heads in wonder. Martha Stewart and her broker tried to use Knicks tickets to persuade her broker's assistant to join ranks and stick with their story about a stop-loss order as the reason for their sudden sale of her ImClone shares one day before the company announced that FDA approval would not be forthcoming for its anticancer drug and star product, Erbitux. Add to this amateur tool of persuasion the altered phone logs, changed stop-loss-order date, and inconsistent stories among these three musketeers of manipulation, and the whole scenario has all the sophistication of elementary-school children caught lifting cookies from the cafeteria line. The conduct, whether over shares of stock or Toll House cookies, is wrong. When the SEC or school principal steps in, the fallout is always the same. One of the amateur conspirators breaks ranks on the concocted, unimaginative story.

This behavior is not exactly the stuff of the so-called gray area. Nor are any of the activities of the companies and their officers we will look at be nuanced. Former Tyco CEO Dennis Kozlowski and his \$6,000 shower curtain for his highfalutin apartment, all at Tyco expense, is not the kind of story that causes us to ponder, "Wow, that was really a subtle ethical issue. I never would have seen that." Maurice "Hank" Greenberg, the former CEO of AIG, found a board waiting with his walking papers when revelations about creative insurance policies and even more creative accounting for such became public. The board had no difficulty in spotting the ethical lapses there. Nor should those in the company—or Greenberg, for that matter—have had any great mental or philosophical strain in spotting the issue. Somehow, however, the issue trotted right by very bright and capable employees and executives who are well trained in accounting, insurance, and where the two meet.

What we have seen and continue to witness is ethically "dumb" behavior. There was no discussion of gray areas as these stories unfolded. When WorldCom was forced to reveal that its officers had capitalized $11 billion in ordinary expenses, no one slapped his forehead and said, "Gosh, I never would have seen that ethical issue coming!"

When Enron collapsed because it had created more than three thousand off-the-books entities in order to make its debt burden look better and its financial picture seem brighter, no one looked at the Caribbean infrastructure of deceit and muttered, "Wow—that was really a nuanced ethical issue."

There have been so many of these not-so-subtle corporate ethical missteps: HealthSouth's fabricated numbers that had it meeting its earnings goals for a phenomenal forty-seven quarters in a row; Royal Dutch's overstatement of reserves; Adelphia officers' personal use of company funds for family and personal projects; and Marsh & McLennan's illegal fee arrangements in exchange for insurance bids. No one looked at Frank Quattrone and Arthur Andersen and their document shredding and wondered, "Would I have been able to see that coming?" Even when there is no criminal behavior, the magnitude of the ethical lapses finds us shaking our heads as companies and careers crash and burn. Smart and talented people make career-ending decisions as they lead their companies and organizations to ethical collapse. Quattrone's and Andersen's verdict reversals tell us their conduct was legal. Why, however, take the risk of document destruction when your company faces regulatory scrutiny? Finding the solution to this seemingly inexplicable march to self-destruction should be the focus of all ethics programs.

These ethical missteps are not the stuff of complexity or even debate. They were downright gross ethical breaches. Indeed, in many of the cases there were blatant violations of laws and basic accounting. But if the problems and missteps were so obvious, how come those involved—bright and with years of business experience—let them slip by or joined in on the fraud festivities? Why didn't someone in the company step up and correct the behavior? And how come no one in the company told the board? Perhaps mentioned it to a regulator? Was there not a lawyer in the house? Why does it take so long before the charade of solvency is dropped? What makes people with graduate degrees in law and business come to work and shred documents or forge bank statements? Why do good, smart people do ethically dumb things?

When Martha Stewart was indicted—and her indictment followed on the heels of the Enron, WorldCom, Adelphia, HealthSouth, and Kozlowski indictments—a reporter asked me, "What is the difference between you and me and a Martha Stewart or a Jeffrey Skilling of Enron or a John Rigas of Adelphia?"

My reply was "Not much."

The reporter was taken aback, outraged that I would not portray these icons of greed as one-eyed Cyclopes with radically different, mutantly unethical DNA.

Sure, Martha and her obstruction, Andrew Fastow and his spinning off debt, and Dennis Kozlowski and his chutzpah with the corporate kitty are the end of the line for ethical collapse. Yes, yes, they descended quite far into the depths of ethical missteps, but no one should assume a perch detached and above this type of behavior. No one wakes up one day and decides, "You know what would be good? A gigantic fraud! I think I'll perpetuate a myth through accounting fraud and make money that way." Nor does anyone suddenly wake up and exclaim, "Forgery! Forging bank documents to show lots of assets. There's the key to business success."

These icons of ethical collapse did not descend into the depths of misdeeds overnight. Nor did they descend alone. To be able to forge bank documents, one needs a fairly large staff and a great many averted eyes. To drain the corporate treasury for personal use requires many pacts of silence among staff and even board members. Overstating the company's reserves requires more than one signature. Those who are indicted may have made the accounting entries, approved the defective product launch, ordered the shredding, or skirted the law. But they were not alone. They had to have help, or at least benign neglect from others in the organization.

Which leads to these questions: How does an organization allow individuals to engage in such behavior? What goes wrong in a company that permits executives to profit and pilfer as sullen but mute employees stand idle?

The latest federal reforms on accounting, corporate governance, and financial reporting, in the form of the Sarbanes-Oxley Act of 2002 (SOX, as it is fondly known among executives), have lawyers and accountants scrambling to meet requirements for ethics programs and other statutory mandates. The demands of SOX represent the third great regulatory reform I have witnessed in my nearly three decades of detached academic observation and research. When Boesky, Milken, and junk bonds stormed Wall Street and then collapsed, we passed massive reforms and we all swore, in Edgar Allan Poe fashion, "Nevermore."

But then came the savings and loans, real estate investments, appraisers with conflicts of interest, Charles Keating, and the inevitable collapse that follows self-dealing and enrichment, as well as the accompanying damage to the retail investors in these enterprises. So we passed more massive federal reforms on S&Ls, accounting, and appraisal, swearing and quoting, once again, "Nevermore!"

Yet here we are, five years after Enron's collapse, still debating all the rules and regulations that should be applied and grappling with the complexities and demands of Sarbanes-Oxley, and this time we swear that we really mean it when we say, "Nevermore!"

But it will all happen again as the cycle continues, because we keep trying to legislate ethical behavior. There are not enough lawyers, legislators, sessions, or votes to close every possible loophole that can be found as we continue to regulate business behavior. Professor Richard Leftwich has offered this description of the relationship between accounting rules and standards and business practice: "It takes FASB [The Financial Accounting Standards Board] two years to issue a ruling and the investment bankers two weeks to figure out a way around it."

The penalties increase with each massive regulatory reform, but so also does the size of the frauds and collapses. This latest go-round of ethical collapses has brought us several of the top ten corporate bankruptcies of all time. Although that list is a tough call. I am reluctant to name these companies to the list because I have to rely on their numbers for that ranking. Who could say how big their bankruptcies really are?

These massive legislative and regulatory reforms cannot solve the underlying problems. They are not the cure for the disease of fraud. The audits, the corporate governance, and the accounting focus on getting good numbers are superficial fixes. Legal changes create artificial hope that massive regulations will stop ethical lapses. But these facile solutions of how to count, when to count, and even how many board members count as independent and which ones qualify as experts in finance have not worked in the past and will not work to prevent similar collapses in the future. The focus on detailed rules makes us overlook the qualitative factors that have more control over the ethical culture of organizations.

Prevention is the key. Stopping the inexorable march to that ethical cliff demands something more than a look at ROE (return on equity) and other financial measures and promised deliverables that are so easily quantified. There are qualitative characteristics to look for in companies that can provide insight into the organizations that produce the external facade of financial