Dangerous currents

Here is what can prompt even ordinary people to do bad things, and what board members must watch like hawks if they want to avoid ethical catastrophe. **By Thomas Donaldson**

I THINK I KNOW what causes most corporate ethical disasters, and it's not what many business leaders believe.

First, let's establish what *doesn't* prompt most ethical disasters, despite popular views. Most such disasters are not caused by the failure of either compliance systems or codes of ethics. To be sure, codes and compliance systems are important tools for corporate management, and we can always show that they failed in a fashion when corporations meet ethical disaster, albeit after the fact.

The growing weight of academic research shows little or no correlation between having a sophisticated compliance system and code of ethics — or, indeed, having an ethical training program — on the one hand, and avoiding ethical disaster on the other. When I testified in the Senate during the Sarbanes-Oxley hearings, I had to remind senators that virtually all the corporations that fell from grace — the Enrons, WorldComs, and Tycos — had sophisticated compliance programs and sophisticated codes of ethics. Jeffrey Skilling, of Enron infamy, was regarded widely as the man who beefed up compliance at Enron.

Nor are most corporate ethical disasters caused by ethical greed-heads. Of course greedy, egoistic executives — or, at a minimum, ones who exercised awful ethical judgment — can be found at the epicenter of almost every corporate Watergate. But to attribute the recent spate of corporate scandals to a few bad apples is unconscionably naïve. Greed-heads and egoists have been with us for years.

A cosmic confluence?

Why, then, did the recent scandals occur when they did, during a brief three-year span beginning in the late 1990s? Was there at that time a cosmic, accidental confluence of moral idiocy? It seems unlikely.

The "bad apple" autopsy of the Enron-age scandals also neglects one of the most striking aspects of those events. Behind each one of the greed-driven leaders there were scores of other people *inside* their corporations who knew what was happening, and were necessary in making it happen. Still further, *outside* those companies there were thousands, probably tens of thousands, of people in law firms, investment banks, and accounting firms, who played a supporting role.

The haunting fact is that most of these thousands of people had remarkably ordinary moral profiles that qualified them as neither saints nor sinners. They were all too ordinary. And yet it is these people, and not the infamous rogues, who lie at the bottom of the big mystery of how triumphant corporations can fall so very hard. This fact — the ordinariness of so many people caught up in corporate Watergates — stands out not only in the Enron-era scandals but also in such high-stakes scandals of the past as Salomon Brothers, E.F. Hutton, Bankers Trust, Prudential, and Merrill Lynch.

What, then, can prompt even ordinary people to do bad things? And what must board members watch like hawks if they want to avoid ethical catastrophe?

The real culprits

A growing body of research and experience in the field of business ethics suggests that the real culprits are what I

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choose to call "dangerous currents." Dangerous currents are what corporate leaders and members of boards must manage in order to help prevent even ordinary people from doing bad things. They are:

— Goal Mesmerization
— Blind Precedents
— Uncommon Stress
— Isolated Teams or Performers
— Discussion Vacuum
— Failure to Anticipate Challenges and Develop Appropriate Principles/Stories/Examples/Language.

These factors constitute a syndrome that can be found amid the rubble of almost every major corporate ethical disaster.

1. Goal Mesmerization

When executives are surveyed, they regularly identify unreasonable targets and goals as the most prominent pressure on their desire to behave ethically. Sears, Bausch & Lomb, and Heinz are examples of companies whose earlier incentive schemes became well-known (through business school case studies and media articles) for having driven unethical behavior.

No surprise, then: How companies pay people makes a difference in the quality of their ethical behavior. When Skilling lavishly rewarded the Enron manager who had created Enron Online in 2000, he praised the innovator publicly for smuggling funds out of another part of Enron in order to get her fledgling enterprise under way. And Enron's rank-and-yank reward system drove frantic actions among thousands of Enron's employees, as Sherron Watkins, the whistleblower, has recently detailed. These two signals — Skilling's witness to what really counted at Enron, and the dominance of a rank-and-yank culture — almost certainly mattered more to Enron managers than any of the company's codes of ethics or ethical training programs.

Rising stars in corporations are often given amazing discretion. This discretion can sink their companies.

Even at the highest levels, goals must map with a company's underlying values; when they do not, corporations are at risk. The rising percentage of CEO and executive remuneration based on stock options in the late 1990s, combined with lax controls on the exercising of such options, no doubt helped fuel the Enron-era scandals.

Granted, stretch goals are powerful strategic tools and need not be abandoned by management or boards. But when stretch goals are implemented in the context of a leadership culture that regularly fails to reward adherence to ethical limits, they become deadly.

2. Blind Precedents

Almost noiselessly, unethical precedents can accumulate in an industry or company until even well-intentioned people unknowingly engage in risky behavior. Consider the slow, steady accumulation of bad precedents in the financial services industry.

During the 1990s I conducted workshops with hundreds of investment bankers. Sometimes I would remind them of the data — known to virtually all of them already — that showed that an investment bank conducting business with a given client was more likely also to have analysts who evaluated the client's equity at higher than average ratings. Or we would discuss the data that showed, at least by the late 1990s, 99 "buy" recommendations from analysts for every "sell." The response was perhaps predictable: namely, no surprise at the data, but the bankers believed that "everybody in the industry did it," and that, furthermore, any firm that detached analysis from investment banking would suffer severe consequences in the marketplace.

I do not believe these people thought that clear, intentional wrongdoing was occurring in their organizations. I do not believe they were bad people. But they had become vaguely aware of a troubling pattern in their industry that constituted a dangerous current — a "blind precedent." More important, they had become completely *unaware* of how the news of such disturbing data would be received by ordinary investors when they finally saw it on the front page of *The Wall Street Journal* or *Financial Times.*

3. Uncommon Stress

Most executives are surprised to learn how often people ruin their careers and impose high costs on their companies through actions taken while under extraordinary stress. Many high achievers regularly burden themselves with stress and sleeplessness. Yet most are unaware of how profoundly such stress can affect their judgment. The engineer in charge at the Union Carbide plant in Bhopal, India, was suffering from sleeplessness and fatigue when, minutes past midnight, a plume of methyl isocyanate sprayed out of the facility, killing 12,000 people outright and injuring 200,000. In this, one of the worst industrial disasters of all time, we will never know whether the engineer might have made better decisions had he been more rested. But it certainly is an interesting question to ask.

4. Isolated Teams or Performers

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The example of Nicholas Leeson of Barings Bank is well known: A young trader, making trades in Singapore, single-handedly wrecked a company so venerable that it had once helped finance the Louisiana Purchase. Less known, but still illustrative, is the securities specialist at Salomon Brothers who quietly attempted to corner the U.S. Treasuries market in the early 1990s and almost brought his company to financial ruin. In the BF Goodrich brake disaster — one of the most reprinted business ethics cases of all time — a young engineer, with only seven years' tenure, was famously left alone to misdesign a brake in an incident that nearly cost one Air Force test pilot his life. Finally, during the early 1990s, Bankers Trust Co. came to celebrate a management style that left smart people nearly unmanaged even as they sold highly leveraged derivatives to corporate clients. These smart people succeeded in cutting the stock value of Bankers Trust in half by 1995 through questionable derivatives sales to companies such as Gibson Greeting Cards and Procter & Gamble.

5. Discussion Vacuum

When bad things can't be talked about in a company, even worse things can happen. The most striking example is the U.S. tobacco industry, which was forced eventually to settle allegations against it for a cost of nearly $300 billion.

The allegations centered on the claim that it hid the truth about cigarette smoking from its customers. From the 1950s until nearly the end of the century, lawyers in the tobacco industry concerned about liability suits had come so firmly to dominate the culture of the industry that discussions of smoking and health were virtually impossible. I remember a personal experience in the mid-1980s in which I spent a day conducting a workshop in Aspen, Colo., for executives of a leading U.S. tobacco company. Near the end of that day I suggested that we could no longer leave aside the question of tobacco and health. The response stunned me. After what seemed like a full minute of embarrassing silence, one participant announced, "We don't believe there is a connection between smoking and health"! That was the extent of discussion of tobacco and health that I managed that day. I learned later that a name existed for what I had experienced — the "tobacco hush." Fear of liability had come so fully to dominate the tobacco industry's culture that people felt forced to remain silent. Yet, arguably, the "tobacco hush" eventually cost the industry hundreds of billions of dollars.

6. Failure to Anticipate Challenges

Most large U.S. companies today have values statements, mission statements, and credo lists. These lists are filled with high-sounding words and phrases such as "respect for the individual," "integrity," and "dedication to the customer." The words are not bad; indeed, when adopted by corporate leaders, mentioned regularly, and embraced when making hard business decisions, the words can play a critical role in maintaining corporate values.

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But too few companies have asked the hard questions in advance about what those words might mean for future challenges. Companies often create such credo statements during better times, when company fortunes look bright. Later, when layoffs appear necessary, they all too often forget the words. But employees do not. Such companies fail to ask in advance, "What does 'respect for the individual' mean when we have to lay people off?"

Many companies could avoid ethical disasters if they anticipated better how their values might be tested. For example, a petroleum company should ask what "integrity" means if it is ever confronted with a request by a developing country to contribute $3 million to a charitable foundation when it is attempting to obtain special drilling rights in that country.

Importance of information conduits

These, then, are the dangerous currents that can bring corporations to ruin and that executives and board members must manage. They are parts of a syndrome recognizable in nearly every one of the past corporate Watergates. They are so dangerous that they can sweep even ordinary people and otherwise good companies away.

Do board members or executives have any control over these dangerous currents? Surely they have *some* control. Indeed, one of the principal challenges for corporate leaders today is managing such dangerous currents to the extent of their ability, so that even pretty good people don't end up doing tragic things. For boards, this inevitably means developing information conduits to and from the corporation that channel relevant "readings" about dangerous currents. It means, at a minimum, that board members must secure independent and reliable information about leadership, culture, and reward systems. But then, that is another story. ■