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THE RIDDLE OF EXECUTIVES' ETHICAL LAPSES: CAN SENIOR LEADERSHIP'S MISCONDUCT BE CURED?

by Joe Folkman and Jack Zenger

The last few years have produced a rash of news accounts detailing unethical behavior on the part of corporate executives. While not a new phenomenon, the number of such incidents and their magnitude exceed anything witnessed in prior decades. Here is just a sample of the organizations involved:

ABB	Invesco
Adelphia	Janus Mutual Funds
Arthur Andersen	Martha Stewart
Computer Associates	Putnam Mutual Funds
Credit Suisse	Shell
Enron	Strong Mutual Funds
HealthSouth	Tyco
Hollinger International	Wachovia
Imclone	Worldcom

Personal lives have been shattered. Formerly prominent and well respected community and business leaders are serving jail sentences. Late night comedians joke that CEO now means "Chief Embezzlement Officer." Enron, at one time the 7th largest corporation in the U.S., had to close its doors due to the misdeeds of a relatively small number of senior people. Other firms have gone through bankruptcy and complete name changes in an attempt to put the scandal behind them.

Why is this happening? With all the rhetoric about corporate ethics during the past decades, and amidst all the pronouncements by senior executives regarding the value of integrity, how do we explain this misbehavior? Paradoxically, corporate executives consistently assert that integrity is the number one quality they seek and reward.

Is there some flaw in our selection processes for senior executives? Are we ignoring early signs of this behavior? Is there anything corporations need to do differently to prevent unethical behavior from their executives? Those are the questions this article addresses.

THE MYSTERY SURROUNDING INTEGRITY

There is a decided mystery that fogs this issue. Here are some of the facts:

1. While the outside world is aghast at the well publicized ethical lapses, people inside the organizations seem rather unconcerned. Added to that, the majority of CEO's in the U.S. have been generally silent about their colleagues' misconduct.
2. When asked to rank in importance a number of dimensions of executive conduct,managers and executives give the highest scores on honesty and integrity.
3. When subordinates, peers and bosses are asked to rank how managers inside organizations are actually behaving on a large number of dimensions, the highest scores are given for ethical and honest behavior.
4. The same assessments performed in companies currently under investigation by various arms of the government also rank honesty and integrity as their

most important attribute,and also give that attribute the highest marks on leadership's current behavior.

5. A lack of integrity and honesty was rarely mentioned in feedback regarding one's immediate leader, even when the ratings of"upper management"showed lower scores on that dimension.

Our research on "fatal flaws" of leaders in organizations uncovered five behaviors that erased or negated all other strengths. But, to our surprise,a lack of honesty and integrity was not one of those five flaws.

Following are some of the statistical studies we've performed that more fully explain the statements above. We analyzed over 200,000 feedback instruments pertaining to approximately 20,000 leaders.[1] Most were from organizations in North America, though a few were from Europe and the Pacific Rim. This analysis was performed to discover the behaviors or attributes that differentiated the most highly performing leaders from those in the lowest quartile. In the analysis we identified 16 differentiating behaviors that most effectively distinguished highly effective leaders. Displaying honesty and integrity was one of the 16 behaviors. The analysis below shows the summary of results of leaders from 10 different organizations.

This chart summarizes our overall data on these leaders:

Note from the previous analysis that the item"displaying honesty and integrity" was the second most positive differentiating behavior across the 10 different organizations.

As noted earlier, one part of our analysis was to identify "fatal flaws."We used this term to describe some behavior or lack of behavior which was always found in those in the bottom tenth percentile and not found in those who were the high performers.

Our analysis indeed revealed five such fatal flaws. They were:

1. Not taking responsibility for the performance of their work group
2. Not taking initiative
3. Lack of good interpersonal skills
4. Not practicing self development
5. Not being open to new ideas or needed changes

The presence of any one of these behaviors appeared to totally erase any good qualities this person possessed. They neutralized a long list of positive attributes. We were extremely surprised that dishonesty and lack of character were not included in these fatal flaws.

In addition, we found little or no hint of dishonesty or lack of integrity in the people we studied. How could this be, given the fact that it seems to appear with some frequency in senior executives?[2]

Even in organizations where serious allegations have been lodged against senior leaders, we could find no hint of any perceptions of lapses in ethical behavior regarding the people in the middle levels. In fact it would appear from the aggregate studies of hundreds of senior executive that honesty and integrity was the area of highest strength and competence even in those organizations which allegedly had experienced serious ethical lapses.

[1] Zenger, John H., and Folkman, Joseph, *The Extraordinary Leader: Turning Good Managers into Great Leaders* (McGraw-Hill, 2009).

[2] Our focus was on managers. There are examples of bond traders whose rogue behavior bankrupted well established firms. This often occurred early in a career. Our observations are confined to middle, upper-middle and senior managers in organizations.

SOME POSSIBLE EXPLANATIONS FOR LACK OF CHARACTER NOT BEING OBSERVED IN MID-LEVEL AND UPPER MID-LEVEL MANAGERS

Several explanations could provide a solution to this mystery.

1. Ethical lapses occur mostly in senior executives because of a new and different combination of forces that impinge on them.
2. These tendencies are latent in many leaders,but there are few opportunities for this behavior to be expressed while serving at middle levels in the organization.
3. Middle managers are more cautious at this stage of their careers.
4. Those who engage in any unethical behavior are quickly eliminated. The salesperson that puts in a "false order" or who makes promises that can't be honored is quickly let go inmost organizations. (But, if this is the case, how do unethical people find their way into the senior ranks? Why weren't they eliminated?)

Whatever the case, the fact of the matter is that the egregious acts of dishonesty that destroyed people's careers and in many cases destroyed entire organizations in their aftermath, were mostly executed by people who were in the most senior positions in their firm.

WHY THIS BEHAVIOR APPEARS IN SENIOR EXECUTIVES

While all of the above reasons may have some validity in solving this riddle, we believe it is caused by the combination of several forces on senior people. Here are the key elements of this new situation:

1. Enormous power over subordinates' destinies which makes underlings reluctant to criticize or blow the whistle.
2. Access to large sums of money that have low visibility.
3. Control over extensive corporate perquisites that can be used for one's personal benefit.
4. Absence of any operational checks and balances.
5. Minimal oversight from the Board of Directors.
6. Huge incentives to reach certain milestones.
7. Relentless pressures from Wall Street to produce continual improvement in quarter-to-quarter results.
8. Belief that they are responsible for the financial success of the firm and therefore deserving of large financial rewards.
9. The "gray" nature of many of the issues with which the executive grapples.
10. The slippery slope phenomenon.

Enormous power

Executives at senior levels have enormous influence and power over others and their careers. This is an order of magnitude greater than the power they enjoyed in a middle management position. The executive is treated with a deference and respect not accorded to someone in middle management. Plus, the executive is usually walled off from honest feedback.

Access to large sums of money with low visibility

Large pools of money are available in the form of reserves and special funds. The CEO and immediate reports have ultimate control overall expenditures and can manipulate budgets with some ease. In some of the most disturbing examples of executive greed, lavish retirement benefits were manipulated to the executives' benefit, often with little or no board oversight,but with simple arrangements between the CEO and CFO.

Control over perquisites

The CEO often brings many long-time friends and allies onto the Board. They populate the key committees, including compensation. Consequently, executives are in a powerful position to influence their personal compensation. Company resources, such as airplanes,apartments, dining facilities, and entertainment opportunities are placed completely under the executive's control.

Absence of checks and balances

Compare the situation of a typical middle manager in a large, well-run corporation with the senior executive who will be morally challenged and cave in. The middle-manager has oversight from other departments, internal auditing looking over his or her shoulder, peer departments in the organization with good visibility into what takes place in other departments, subordinates with personal relationship with other senior managers, and a manager to whom he or she reports who is usually somewhat aware of what is happening inside this leader's department.

The senior executive has just the opposite set of circumstances. It would appear that neither the Board of Directors nor the professional advisers wanted to see nor put forth much effort to ferret out evidence of devious behavior.

> *Enron's 2000 Annual Report stated: "In return,Enron received…a special distribution from the Entities in the amount of $1.2 billion in notes and receivables, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional instruments…" One would think that any Wall St. analyst, Enron Director, or Enron officer reading that statement would have raised an eyebrow about that rhetoric. The message is quite clear. Baldly stated, how much the off-shore, off-book entities paid Enron depended on how much Enron in turn paid the self-same entities. That reciprocal transaction would not be allowed in any customer or supplier relationship.*

No boss

Yes, the CEO reports to the Board. But, the Board members depend on the CEO to supply them with information. Their visibility into the inner workings of the corporation can easily be clouded by the CEO. Finding the reality of what is happening demands taking proactive steps. If the CEO and CFO team up to provide financial statements that are misleading,the Board is operating on incorrect information. Further, the Board members have limited time available and usually resist getting into the detailed workings of the organization,lest they overstep their bounds as Board members.

HUGE INCENTIVES

Computer Associates board created an incentive of $1.1 billion dollars to be shared by less than five executives, based on the organization reaching a certain market capitalization. The executives received this payout, and then a few months later warned of a business slowdown. The stock plummeted. The company was forced to restate improperly booked revenues of $2.2 billion. Four executives later pleaded guilty to these charges.

Given the magnitude of that incentive, should a board be puzzled about the temptation to inflate the stock price? Computer Associates adopted a practice of a "35 day month," pulling in revenues from the following month. And, once starting down that path, it became virtually impossible to correct it.

Anyone who has been involved in some "earn out" in which the final payoff is based on earnings is aware of the temptation to cut expenses,accelerate revenue, defer product development,reduce maintenance and eliminate virtually everything that doesn't have a payout in the specified time period, knowing full well that it mortgages the future.

New pressures

As one reads through the published accounts of many of the tragic cases of executive misbehavior,it often seems driven by the need for the organization to show a steady improvement in its financial performance. So, off-shore partnerships are created to hide losses. New accounting treatments are devised to make earnings appear better than they actually are. Improper revenue recognition practices get put into motion. Wall Street analysts want visibility into the company's earnings, and severely punish the stock if there is not a steady increase in earnings, quarter to quarter. Add to that the desire for the senior executives to look good to the Board, peers and subordinates, as well as to the larger financial community.

The consequence of this pressure is the tendency to push everything and everyone to the limit in order to drive profits. Lawyers and accounting firms are pressured to take aggressive stances on every issue that would affect the profitability of the firm. In an effort to cement their relationship with their client,these advisors have often been the instigators of questionable practices.

The typical middle manager may have pressure from a boss to provide better results; but it is seldom suggested that the means by which one gets there are irrelevant.

A belief that huge rewards are deserved

The popular and business presses have lionized executives, attributing the success of an organization to a few people. Executives have been made to believe that they are personally responsible for corporate success, and thus any conceivable return to them is totally justified. Nothing seems too excessive, even though the ratio of executive compensation to the average worker in the United States is many times higher than that of those who serve in similar roles in Europe,Japan, or other parts of the world.

> *As evidence, consider the statement by Tyco's former general counsel, Mark A. Belnick, who testified that he earned "every dollar" of the $17 million dollar bonus that he was accused of stealing from Tyco.*

Many issues are "gray"

Executives seldom wrestle with issues that are black and white. Most are varying shades of gray. Absent any direction from a Board about its comfort level on the "gray" scale, the executive makes a choice. Often that choice is an attempt to get right to the borderline between gray and those practices that are clearly inappropriate, illegal or unethical. But because that line is often broad and fuzzy, the organization drifts too far.

The slippery slope phenomenon

People often take a small step in an unethical direction with the firm belief that they will make it right and get back on the correct path. An example is the bond trader who has some losses and seeks to cover it up from the boss,believing that it will be covered by tomorrow's gains. The first time revenue is pulled in from the following month to make the previous month meet its target is done with good intentions and often with the assumption that it will not happen again. But, once on this slippery slope, it becomes extremely difficult to hop off.

IS THERE A SOLUTION?

Here are some of the steps we propose.

1. Warn newly appointed executives of the dangerous territory into which they have now arrived, and encourage them to put safeguards in place to prevent misdeeds from occurring.

Greek mythology tells the story of Odysseus who wanted to sail past an island inhabited by three sirens. These sea nymphs lived on an island surrounded by treacherous rocks. The sirens had the body of birds, and the heads of beautiful women,and their song was so enchanting that sailors were mysteriously drawn into the island's rocky shores. Then their ship would wreck and all aboard would be killed. Odysseus decided to sail by the island, but recognizing his vulnerability and that of his sailors, he decided to control his and their behavior. He ordered himself lashed to a mast, so that he could not go to the wheel and turn the ship into the island. He ordered that his sailors have their ears stopped with beeswax making them incapable of hearing the siren's music. With these safeguards in place, they safely navigated past the island.

The powerful lesson in this story is that Odysseus recognized the danger of this new situation, and recognized his and the crew's vulnerability. He took steps to counteract it in advance.

What if corporate executives took proactive steps to prevent unethical behavior? Those steps could include safeguards such as a corporate or Board appointed ombudsman to whom anyone could go with concerns about ethical lapses in the firm. Or, it could be a hotline to an external law firm to which any employee could report in confidence something that appeared to be an ethical lapse.

Recent legislation, such as Sarbannes-Oxley,has called everyone's attention to the responsibility of the CEO and others regarding public statements and the accuracy of financial reports. Another part of this solution is for corporate boards to provide far more detailed oversight, and to find ways to delve into the workings of the organization. As a Board member of one firm, one of the authors learned that he never understood what was truly happening in the organization until he interacted directly with some of the key people and learned first hand about the issues the organization faced.

2. **Strengthen other behaviors that go hand-in-hand with ethical conduct.** In our research on the differentiating competencies of extraordinary leaders, we found an interesting phenomenon. For each differentiating competency, there were several companion behaviors that always went hand-in-hand with that differentiating competency. That is, if a person receiving a high score on a given differentiating competency,he or she always received high scores on 5 to 10 other behaviors at a statistically significant level.

In the arena of ethical conduct and integrity, five companion behaviors stood out. Leaders who were perceived as having high integrity also:

- Seemed approachable
- Acted with humility
- Listened with great intensity
- Made decisions carefully
- Acted assertively

The first four behaviors are interesting in their portrayal of someone who treats others with decided respect. These are not the leaders who"smile up and kick down," nor are they the leaders who are haughty and arrogant and put themselves on a different plane, arguing that the rules others must abide by don't pertain to them.

As we read the accounts of many of the executives who have been charged with serious ethical breaches, we seldom get the picture of an executive who is approachable, who acts with humility, who listens to others with great intensity,and who makes decisions very carefully. To the contrary, we read of leaders who have placed themselves above others and walled themselves off from the rest of the organization.

Further, they seldom practiced much self-development. In fact, it is fascinating to see in our data that the lowest score of executives who are terminated for ethical lapses is their lack of practicing any kind of self-development. A practical manifestation of humility is recognizing the need for self-development.

The final companion behavior, acting assertively,is a fascinating one. We think it has most relevance for the larger population of leaders in the firm, but probably not the most senior executive. In every case of corporate wrongdoing,there appears to have been a relatively small number of people who conceived the ideas to hide losses, engage in deceptive financial reporting, or condone late trading. But,of course, there were many more people who were aware of such practices, but did nothing to bring the misdeeds out in the open.

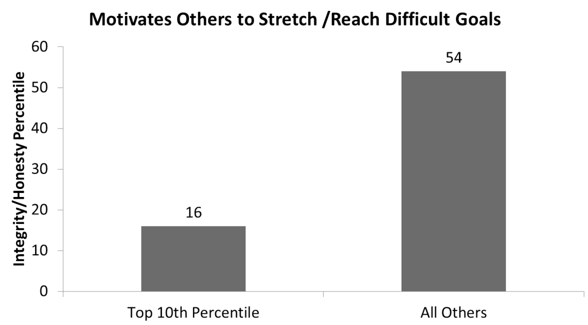
So the issues are:

- Who created the mischief?
- Who had knowledge of it? (These people often justify themselves by saying, "I didn't do it")
- Who had the courage to speak up? (This is assertiveness)

Our research indicates that the people who received high scores on character and integrity were assertive. They focused the searchlight on corporate wrong-doing of any kind. People with the courage to speak up are the most admired,even though this behavior could have repercussions in their short-term role in the company.

Helping people to develop these five companion behaviors would certainly change how the leader is perceived. But there is more to it than that. These five behaviors are inextricably linked to character and integrity in subtle ways. If senior executives were to practice those behaviors at a high level, we believe that breaches of ethical conduct would lessen considerably.

3. Insist that a balanced message is instilled throughout the organization regarding results and the methods by which results are obtained. We have interesting data on those leaders who were perceived as the most ethically challenged. The graph below shows results from senior leaders who were at the 90th percentile on motivating others to stretch in order to reach difficult goals. Those leaders who were pushing others extremely hard on results were rated at the 16th percentile on honesty and integrity. All others leaders (e.g., those below the 90th percentile) were rated on average at the 54th percentile.



We are not suggesting that leaders back off from their drive for good results. But, we are suggesting that this drive for results must be balanced by an equally strong message regarding the methods that are acceptable for attaining those results. When leaders push hard to get results but do not talk about the how we get results, they give the impression that they don't care about "how" as long as they achieve the results.

> *Jack Welch, during his tenure as CEO of General Electric, was a strong exponent of combining a strong message about the need for results with an equally strong message that insisted executives function in accordance with the values of the firm. In an annual report he presented an oft-cited grid on which executives could be placed. The one axis separated those executives who produced good results and those who did not, and the other axis described those who lived by the values of the organization and those who did not. Welch noted that those leaders in the quadrant of high results and living by the values described those in line for promotion. Those in the opposite quadrant were equally easy to deal with. If someone did not produce good results and did not live by the*

values, you should terminate them. Those who lived by the values but who did not produce good results deserved a second chance, probably in a different venue. The most difficult group, according to Welch, was the group who produced good results but who did not live by the values. They, said Welch, needed to be terminated because they would ultimately destroy the organization.

That is exactly what happened in the case of many of the organizations cited at the beginning of this article. These leaders appeared to be producing good results, but were not living by the espoused values of the organization. In some cases this destroyed the organization and in every case seriously tarred its image.

CONCLUSION

Ethical behavior is one of the big issues of this decade. Misconduct on the part of senior executives has tarnished the image of CEO's, their immediate colleagues and some of the professional services firms that have counseled them. More must be done to prepare executives for the unusual confluence of pressures that descend upon them. New methods must be found to prepare leaders to recognize their own vulnerability and to prevent missteps. Our motive is to open a dialogue about the issue and especially about creative solutions. Only in this way will we restore the public's respect and trust, which we readily acknowledge is fully deserved by the great majority of executives.

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Using powerful techniques that focus on building strengths using implementation tools and personalized coaching, our approach lifts the performance of leaders, coaches and individual contributors in the differentiating competencies shared by those who are among the world's most successful people. Our proven, practical methods create a clear picture of how leadership drives profit and the ways to put it to work within organizations.

If you are interested in discussing how your organization can increase profit through extraordinary leadership, please contact Zenger Folkman. We welcome the opportunity to talk with you about how your organization can develop extraordinary leaders who have the competencies to maximize profits for your organization!

John H. "Jack" Zenger, D.B.A., is the co-founder and CEO of Zenger Folkman, and is considered a world expert in the field of leadership development. A highly respected and sought after speaker, consultant and executive coach, Jack was honored in 2011 with the American Society of Training and Development's *Lifetime Achievement Award in Workplace Learning and Performance*. He is the co-author of seven books on leadership and teams, including the best seller: *The Extraordinary Leader: Turning Good Managers into Great Leaders* (McGraw-Hill, 2009).

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