BROKEN BUSINESS

SEVEN STEPS TO REFORM GOOD COMPANIES GONE BAD

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PART I

INTRODUCTION

A fish rots from the head down.

—Greek proverb

In 2005, I started advising a global automotive manufacturer headquartered in Germany with more than 300 000 employees and a market capitalization of $100 billion. The organization has an iconic brand, deeply historical and traditional roots, and a complex system of building their products and

distributing them to almost every country around the globe. It was (and still is) a mighty and very impressive organization.

A year earlier, however, US authorities had received allegations by a former internal auditor concerning accounts used for corrupt means. This led to civil and criminal investigations. Teams of lawyers and forensic accountants were brought in by the company to conduct an internal investigation.

Years of investigation followed, leading to extensive and costly remediation activities to clean up the improper conduct. Eventually, the company reached what is known as a Deferred Prosecution Agreement or DPA with the US Department of Justice. Essentially, this is a plea-bargain and settlement agreement between an organization and prosecutors, approved by a court, whereby facts on alleged misconduct, fines, and penalties are all agreed and documented, in exchange for avoiding a trial.

My firm was brought on board one year after the internal investigation was started. Our initial task was to remediate the books and strengthen internal controls. We had to bring off-balance-sheet accounts back into the books; reverse prior actions that created slush funds; and establish emergency measures to prevent improper payments from continuing. It was an extremely complex case rife with a whole host of accounting and legal challenges.

But the biggest challenge of all was a human one.

I remember attending a meeting early in my time at the company and being introduced to the company's head of sales for emerging markets, which covered over 100 countries. He was a magnetic force who could pull you into his orbit and make you feel like the most important person in the room with his handshake and soft voice. This affable fellow was a very close friend of the outgoing CEO. He was a long-term executive who had built an emerging market business in his own entrepreneurial way. He was worshiped within the company.

And he was the person at the epicentre of the scandal and corruption. The corrupt accounts were his handiwork. Fortunately, I had a good sense of all this before meeting him, or he might have won me over too.

It took significant investigating, fact-gathering, and case-building, but eventually that senior executive was removed (along with his cohorts), and the incoming CEO and newly-appointed CFO moved the troubled company from a paralysed crisis situation into a period of frenzied and productive activity. They cleaned up the misconduct and built new internal control structures. They found a number of other areas that had been tainted and remediated them. After years of work, they then moved to address more systemic business issues. They radically redesigned how the company approached

key markets, reducing complexity and increasing transparency and oversight. The company also took a new approach toward its top executives, paying close attention to their ethical judgements, particularly in how they managed company resources. In 2006, we supported the design and implementation of a new anti-corruption compliance programme. Company leaders held hundreds of town hall meetings to address ethical issues openly and take ownership of the organizational change efforts that were necessary.

It was no longer business as usual. Within years, the organization had been reborn with a strong foundation formed by an integrity-focused culture, a simplified market strategy, and stronger compliance structures to minimize the chances of misconduct recurring and going unaddressed. As part of this change, they also implemented effective allegation management and investigation mechanisms to ensure that all signals of misconduct were adequately identified, investigated, and remediated promptly.

Toward the end of my firm's involvement, the Chairman of the company expressed gratitude for the independent vision for change we had brought to the company. The changes instituted did not quash innovation, profits, or the entrepreneurial spirit. Quite the contrary. This company moved from being number three to number one in their segment, achieving such a remarkable goal in less time than originally expected.

Recovery from ethical crises comes from within an organization, through leaders that inspire integrity and take accountability seriously. My firm simply functioned as an agent for change, bringing the element of experience, independence and unique context to better inform decision-making.

Over the years, we have taken similar journeys with a number of other great companies facing a dark period. This book brings their stories together.

THE PROBLEM

Public and regulatory intolerance for corporate misconduct has increased sharply in the last two decades as we've found ourselves witnessing some of the biggest corporate scandals in history. The Enron scandal occurred in 2001, but its aftermath continues to reverberate. I vividly remember the frenzied activity surrounding the internal control requirements that came with the passing of the Sarbanes–Oxley Act of 2002 in the US. The CEOs and CFOs that I worked with were reluctant and nervous to sign the quarterly certifications that accompanied their financial statements. They had always been responsible for signing representation letters for their auditors, but now it was different as they found themselves with substantially more personal liability for their companies' finances and financial controls.

Enron is still widely cited as a cautionary tale, especially since the company had prominent Board members and seemingly

impressive governance and control structures (similar to Theranos in 2008). In the years following its shocking and rapid descent into bankruptcy, there were many advances in the development of corporate governance principles and a heightened focus on financial reporting controls.

In 2003, I was part of the investigation and remediation team on a fraud matter in The Netherlands that was considered 'Europe's Enron'. The case showed companies outside the US that the issues were not isolated to America; rather, they could happen to the best companies, icons of business, anywhere in the world. Local folks were shocked at the levels of misconduct found at such a venerable European company: a company that was over 100 years old and had operations in the US, Asia, Latin America, and Europe. We worked for over two years with this company and liaised with the authorities. One executive did eventually serve time in jail in the US; others were given house arrest, fined and/or received suspended sentences.

Fast forward to the financial crisis of 2008 – a massive worldwide phenomenon that was triggered by subprime lending and faulty investment schemes in the US. This led to enormous government bailouts of major financial institutions previously considered infallible. The shocks reverberated across the globe, with bailouts and nationalization programmes spanning various continents. It was corporate greed, collusion, and a deficient system of checks and balances that caused such incredible

damage, but it was public money that went to saving these institutions.

Behind this financial crisis came the tax evasion and money laundering scandals that opened the secrecy veil behind Switzerland and other nations, then spreading to a worldwide movement. The LIBOR scandal followed shortly after that, with bankers colluding to cheat in the setting of interest benchmarks tied to trillions of dollars of market positions.

The fact that the public is not ready to forgive and forget is still constantly made clear in news reports, social media, and daily conversation. The prevailing sentiment was captured in the popular and critically praised 2015 film *The Big Short*, a cynical comedy that mocked the people and organizations that caused the great crisis while lamenting its effects. Today, public trust in our corporate institutions is deeply and perhaps permanently damaged.

It doesn't stop there. As anyone who works in a regulated industry knows, lawmakers and regulators around the world have adopted a very different tone in the wake of these scandals, and there is an inexorable march toward more and more regulation and compliance.

In this environment, the cost of a corporate scandal is extremely high. This is aggravated by the fact that bad news

now travels the world with the click of a button, so a situation can snowball and become ever more difficult to slow down or contain. No one wants to be associated with a company plagued by scandal.

A scandal triggers a crisis. Almost immediately, the market capitalization drops and questions about top leadership hit the editorial pages. Customers become nervous, especially those that are procuring complex, multi-year projects. Suppliers worry about the cash crunch and tighten their credit lines. Banks become worried about potential credit downgrades and collateral requirements, and know that the organization can expect significant additional costs to deal with the crisis. Management becomes distracted, focusing on survival rather than long-term plans. Raising capital in the market becomes tricky because of potential additional liability that can come from new disclosures or representations. The cost of capital increases. Employees become nervous. Top talent start exploring alternative employment options. Companies then start to invest in retention bonuses, just to keep those few key folks in place. In due course, a restructuring is announced to save cash. Employee disenchantment and uncertainty starts to spread; motivation falls. With a depressed stock price, the threat of becoming a takeover target is real. Hundreds of consultants start to move in for all types of projects, only adding to the cost, uncertainty, and feeling of chaos.

The message is simple: White-collar crime has large and painful costs and consequences.

* * *

When a company finds itself in a crisis because of corporate misconduct, we may wonder what the root of it may be. Is it because the company's leaders were greedy and corrupt, as the media teaches and as so many people are inclined to believe? Based on my experience, I don't think so. I have worked with too many senior business leaders to buy into that convenient but overly simplistic viewpoint. The vast majority of people running these major corporations have a genuine desire to do the best for the shareholders, their employees, and their customers.

So, what causes it then?

My view is that good companies, with smart leaders, end up on the wrong side of the law due to *systemic business failures* – structural, strategic, and cultural breakdowns that occur concurrently within companies. These systemic business failures result from ill-conceived (and initially well-rationalized) choices made by top business leaders; they come from ill-judged management choices. Years prior to a scandal, these leaders were informed of misconduct allegations involving key personnel and important market areas. A certain level of fact-finding took place but it was inadequate. To avoid rocking the boat, these leaders decided not to probe deeper or take adequate remedial action. They allowed their judgement to

become clouded by the desire to protect the corporate reputation and the superstars that deliver large ideas and major projects. An insular corporate culture added to the toxic brew that became fertile ground for white-collar crime and inappropriate conduct festered.

Typically, business leaders involved in wrongdoing don't set out to do wrong. Quite the opposite: they aspire to do the right thing and see themselves and their organizations as doing good. But they take small, incremental steps that foster misconduct and fail to appreciate how far down the slippery slope they've gone until it's too late. Systemic business failures can occur at the very best of organizations, especially those that have highly intelligent, creative, and charismatic senior employees. These superstar managers tend to subvert fact-finding, can rationalize problematic actions, and know how to use their power and influence. Confusion and lack of clarity helps them achieve their means.

Instances of corporate misconduct that may initially seem to be isolated often reveal deeply entrenched issues. In most cases there were early warning signs: allegations of misconduct that wound their way through the company but were dismissed or addressed only superficially.

For example, a CEO may give a pass to a high-flying sales manager who approves hidden and inappropriate gifts to clients and

benefits from receiving sensitive, inside, and proprietary information. The CEO gets comfort from the fact that a third party handled the dirty work on the company's behalf. Some of this information may be revealed as part of a recent internal audit. Since the organization trusts this high-flyer and wants that person to keep on producing the big deals, they convince themselves that the executive meant well and it is the third party that is to blame. This superstar is then given a pass. Months later this person is promoted after winning another major deal.

Incentive-based compensation systems, when followed too rigidly in the fight to meet intense capital market pressures, can lead to a corrosive culture characterized by: a 'no excuses' approach to meeting performance targets; a 'move up or get out' model for employee advancement; and a 'naming and shaming' response to those that don't conform to protocols. Individuals that don't fall in line know that they will lose their job or be marginalized. Those that conform may get bonuses and be promoted. The calculus is clear.

Company leaders and media reports often like to cite a few 'bad apples' as the source of the problem when corporate scandals strike, and these unscrupulous individuals do indeed exist. But they would not and could not thrive unless the environment in which they operate allows them to. These are people who prey on weak systems at seemingly good companies. They are not outsiders but entrenched and revered insiders who hold

positions of power. This makes a scandal that much more difficult to address – we see the perpetrator and realize we are dealing with one of us, a respected member of the team, with allegations that are simultaneously easy to believe and painful to accept. Why? Because they signal that a part of my organization has been less than pure.

We don't like to learn that. We go to work every day for important organizations that do work that is both valuable and valued. We believe in the cause. Most people – those who like their jobs, anyway – care about their companies and believe they are making a meaningful contribution. When a scandal hits, it becomes personal and it triggers doubt about the many things learned and absorbed over the many years of service.

A major contributor to corporate scandal and failure comes from a strategy to be number one, but without a complementary emphasis on how to get there in a rational and healthy way. Being the best is measured in numbers: market share, volume of units sold, relative position to competitors, revenue growth, and profits. Sometimes organic growth is not enough, so a company goes on a spree of acquisitions. But rather than thoughtfully integrating new operations in a way that maintains a strong culture, the company builds itself on a weak foundation and becomes unwieldy and overly complex. Customers become numbers, products are merely units, and corporate values are just ignored colour posters near the water cooler. This creates

an environment where corruption and misconduct can breed, fester, and grow.

Take, for example, the automotive sector. Between 2005 and 2015, the companies that have been number one in global automobile unit sales have all been stung with major allegations of criminal misconduct, starting the painful process of investigation, costly remediation, and reputational damage. Their fines, penalties, and collateral damage amounted to billions of dollars. These global automotive players became number one again in their segments after responding to their crisis, fundamentally changing, rebuilding their leadership and structures, and employing more sustainable business models.

As we will see, bad conduct and executive missteps, in some form or another, are impossible to avoid. Attributes that lead to bad behaviour are essentially embedded into the DNA of the human race. Therefore, good stewardship calls for adequate planning for such events. The goal is for wrongdoing to be identified and investigated quickly, for remediation to take place expeditiously, and for steps to be taken to limit the damage to the organization – in that order.

Managing a business is complex work. Leaders can't have their eye on everything at once; non-executives have even less of a chance of having a complete picture. A sound corporate strategy is important, and it must be supported by a

strong culture that holds people accountable for their actions (and inaction). Checks and balances need to be in place, with robust compliance and control structures. Transparency on key problems in an organization, especially allegations of misconduct, takes on paramount importance. In addressing allegations of misconduct, half-measures will begin to damage a company's moral compass, and misdirect it onto a path toward future scandal.

Every company is unique, but certain patterns of failure emerge time and again. These will be explored in the next chapter through the tale of Wind International, followed by a review of psychology research into the human factors that make misconduct all but inevitable.

THE SOLUTION

Most large companies are sophisticated enough to manage a public relations crisis. They know the right moves to make when wrongdoing has been uncovered or alleged and, perhaps more significantly, they know how to ensure that the public *sees* the right moves they are making. But efforts geared at damage control generally do not go deep enough to get at the core issues that caused the problem in the first place. Real change – transformative change – must go deeper to ensure that the underlying sources of misconduct are identified and addressed, to limit the possibility of recidivism or another crisis in the future.

This book presents a solution to address the systemic business failures behind corporate misconduct. Empowering Integrity serves as a leadership roadmap and a framework for action that can be applied to organizations of any size and purpose. The process includes seven steps that guide a company moving from responding to a crisis situation, to rebuilding organizational structures, to transforming the way the company does business. These steps are:

1. Understand the crisis.
2. Undertake an independent investigation.
3. Define a roadmap to recovery and remediation.
4. Achieve criminal and civil resolution.
5. Strengthen structures to prevent, detect, and respond to misconduct.
6. Reshape the culture.
7. Refocus the strategy.

As mentioned in the Preface, the first four steps get a company out of a crisis, including plea-bargaining with authorities, and the last three help ensure that the next crisis never happens. To reinforce this distinction, the steps have been split across two parts of the book.

The second group of steps (5 through 7) put in place the systems, processes, and practices for institutionalizing corporate integrity and good conduct. They also provide pillars to transform how organizations do business ethically and responsibly.

A NEW KIND OF LEADERSHIP

In my work, I have seen numerous respected and well-meaning CEOs, directors, and executives forced to step down and have their reputations irretrievably tarnished by a scandal that occurred under their watch. They had inadvertently executed faulty strategies, put weak systems in place, and become blind to misconduct within their organizations.

I have also seen bad guys celebrated as good guys for far too long. That is, I have seen corporate superstar managers – senior VPs, presidents, and even CEOs who are rulers of their own fiefdoms within companies – feted and rewarded even as their behind-the-scenes conduct slowly rotted away the culture of integrity the company was trying to maintain.

And I have seen good guys be made to feel like bad guys and suffer as a result. Too frequently, I have seen corporate officers and whistle-blowers who genuinely wanted to do the right thing, taking both a personal and professional risk to expose bad practices. They then find themselves silenced, ignored, ostracized, or shuffled out of the way, their careers bearing permanent scars and with ongoing fear of further retribution.

All of this is the result of well-meaning but faulty leadership. In the conclusion to the book, I explore what it means to recalibrate one's sense of leadership. A recalibrated sense of leadership will

help executives identify and act on the warning signals, be better equipped with additional insights and possess a more effective context to frame decision-making at their organizations.

Which is not to say that this book is a call for an alternative to the current capitalist framework for business. It is not, and I am not a corporate evangelist. Our current system may be flawed, but it's the best we've got, so the messages and advice contained herein are dedicated to how to best correct the imperfections in a flawed system.