# *IWS Issue Briefs*

## Ethical Leadership and the Price of Bad Behavior

Corporate scandals have become something of a commonplace in the past few years. Executives have been indicted for fraudulent financial schemes, conspiracy, lying to investigators, insider trading, and assorted other wrongs. They have been publicly chastised, along with company directors who authorized the questionable arrangements, for pulling down super-sized compensation packages even as indicators of corporate performance have lagged. The seeming lapse in corporate values is so politically charged that it has emerged as another partisan club in the run-up to the presidential election in November.

The combination of bad news and bad behavior has created a crisis of confidence in America's business community. Opinion polls taken nearly two years ago by Gallup/CNN/*USA Today* and ABC News/*Washington Post* and now posted on the Public Agenda Web site already showed widespread popular belief that top executives take actions that benefit themselves at the expense of their companies, that financial audits hide damaging information, and that large corporations' financial reporting problems are indicative of similar problems among many companies. Given the perception and the reality, a growing chorus of academics, consultants, politicians, investors, and corporate leaders themselves have embraced the concept of ethical leadership as both antidote and deterrent.

Like many abstract notions, ethical leadership lacks a certain specificity of definition. Those who write, teach, research, and advise on the subject tend to use adjectives such as honest, trustworthy, credible, incorruptible, and courageous to describe the intangible personal qualities of an ethical leader. In general, say the experts, ethical leaders consistently set and uphold standards informed by irreproachable values and principles, serve as role models for "doing the right thing," influence subordinates to behave likewise, ensure integrity and transparency in all transactions, and adopt policies, pursue strategies, and make decisions that serve the best interests of all stakeholders, including shareholders, customers, suppliers, and employees. Indeed, events of the past few years have propelled the linked concepts of ethical leadership and business ethics from the domain of triviality to the domain of big-time relevance.

The costs of unethical behavior for the corporation, for the perpetrators, and for other stakeholders are potentially catastrophic: insolvency, decimated stock values, ruined reputations, monetary fines, jail terms, resignations, reduced orders, and massive layoffs. WorldCom Inc., now operating as MCI Inc., declared bankruptcy in July, 2002 on the heels of an $11 billion accounting fraud. Enron Corp. imploded in December, 2001 after a strategy to hide billions of dollars in debt and inflate profits through off-balance sheet borrowing (while personally enriching a select few) cracked apart. Boeing Co.'s chief executive resigned in November, 2003 following a series of ethical missteps that strained its long-standing contracting relationship with the United States government and a week after the firing of its chief financial officer over his recruitment of a retiring Department of Defense official with whom he negotiated contracts. Adelphia Communications

Corp.'s founder, his two sons and a former executive went on trial early this year for conspiracy and bank and securities fraud linked to the company's collapse in 2002. The mutual funds industry has been fined by legal authorities and forced to change certain trading and pricing practices that unfairly benefited only the most privileged clients. Other examples abound.

Sometimes the ethics issue involves excessive compensation arising from the combined total of straight salary, bonus, and exercised stock options. Such payments are generally not illegal – directors, after all, have approved the packages – but they are increasingly judged unseemly and unwarranted. The chair and chief executive of Walt Disney Inc. took home more than $7 million in 2003 despite years of stagnating profits and stock price. More than two-fifths of Disney shareholders recently signaled their displeasure with the executive's performance by withholding their votes for his re-election to the board of directors during the 2004 annual meeting; he subsequently lost his position as chairman of the board. The head of AMR Corp, parent of American Airlines, was fired after awarding rich retention bonuses to six executives and setting up a $41 million fund to protect the pension's of 45 managers even as he pressured employee unions to accept concessions so the company could avoid bankruptcy. The chair and chief executive of the New York Stock Exchange was forced to resign last fall after public outcry over a compensation package worth $140 million; the executive noted at one point that the exchange actually owed him another $48 million. In mid-April, regulators signaled their intent to sue the former executive to recover some of the money.

Recent data on chief executive compensation indicate that top corporate officers continue to be handsomely rewarded, even though increases are relatively modest compared to the go-go years of the late 1990s. *Business Week* magazine reported in its annual survey of CEO pay (April 19, 2004) that average salary, bonus, and long-term compensation rose 9.1% to $8.1 million in 2003. The 25 top executive earners pulled down pay packages that were, on average, more than 900 times the yearly salary of a typical American worker. And then there are the perks, such as free use of the corporate jet for personal travel, whose monetary value is not figured into the overall compensation numbers. Some observers, including executive recruiters, consultants, and academics, justify such pay levels given the responsibilities borne by top corporate officers and the thin pool of qualified candidates.

But increasingly such rationalizations ring hollow. A deep and lengthy recession, dubious business decisions, displays of personal greed, the disappearance of hundreds of thousands of well-paying manufacturing jobs, corporate boards controlled by company executives and chummy outside directors, and loose bookkeeping and sometimes illegal financial dealings have all cast doubt on the appropriateness of exorbitant pay. The enormous run up in CEO remuneration over the past two decades has offended even some Wall Street denizens. William McDonough, the former president of the Federal Reserve Bank of New York and now chief of the new Public Company Accounting Oversight Board, has pointed out that the ratio of average CEO compensation to average production worker compensation was 400-to-1 in 2002 compared to 42-to-1 in 1982. Such skyrocketing pay, Mr. McDonough has said, reflects "terribly bad social policy and perhaps even bad morals." A survey of corporate ethics officers by the Conference Board in 2003 found that six out of ten respondents believed compensation for senior executives was "out of control."

The ethics situation has become so critical that Congress, the Securities and Exchange Commission (SEC), and several large pension funds are forcing the private sector to focus on, and clean up, corporate governance. The Sarbanes-Oxley Act (a.k.a. the "corporate responsibility act"), passed in 2002, requires all chief executives and chief financial officers to certify the accuracy and veracity of financial reports, calls for harsh penalties for accounting fraud, creates a felony for securities fraud, and establishes a federal oversight board for the accounting industry. The SEC requires listed companies to disclose if they have a code of ethics and its chair, William Donaldson, has called on corporate directors "to determine the elements that must be embedded in the company's moral DNA" to serve as the foundation for a corporate culture that includes "high ethical standards and accountability."

Investors, meanwhile, are increasingly agitated about these issues. According to the Investor Responsibility Research Center, an impartial provider of research and information on corporate governance and social responsibility, activist shareholders filed more than 650 proposals during this spring's proxy season to be considered at annual meetings in 2004. As identified by Institutional Shareholder Services, Inc., which provides proxy voting and corporate governance services, a sizeable proportion of proposals pertained to executive compensation, financial audits, and boards of directors. Shareholders are pressing directors to link executive pay to performance, to report stock options as expenses, to require shareholder votes on golden parachutes (severance packages), and to uncouple the board chair's position from that of chief executive. They are also seeking to make boards independent from management and to elect all directors annually, and asking for process changes that would facilitate greater accountability by auditors to shareholders. Although shareholder resolutions are not binding even when they win majority support, a growing number of companies have been adopting the recommendations.

Institutional shareholders, who manage billions of dollars in assets and control relatively large blocks of stock, often lead the dissent. The California Public Employees' Retirement System (CalPERS), the country's largest pension fund, maintains a web-based shareholder forum on executive compensation. In mid-April, CalPERS announced it would withhold votes to re-elect as directors both the chair and the chief executive of Citigroup because of corporate governance concerns. TIAA-CREF, the pension fund for college and university educators, has written a policy statement on corporate governance that includes, among other topics, sections on executive compensation, social responsibility, boards of directors, and shareholders' rights.

Human resources (HR) professionals have a role to play as the drive towards ethical leadership and tighter, more transparent corporate governance gains speed. For one thing, they can reinforce with top executives that the commitment to ethical leadership starts at the apex of the hierarchical triangle. Executives must lead the way, with words and actions. They should model ethical behavior and hold subordinates accountable for same, and so on down through the organization. HR professionals can help executives develop the policies, codes, and standards that can shape and reinforce a culture that encourages employees to ask questions, guarantees confidentiality for whistleblowers, does not penalize the reporting of problems or missteps, tolerates candor and dissent, promotes compliance with external laws and internal rules, and embraces values-based decision-making. HR recruiters can develop techniques that screen job candidates for personal and professional integrity while other HR specialists can work with line managers to ensure that ethical behavior is supported through performance reviews and decisions about compensation and promotion.

Ethics training for all employees, including senior management, is also imperative. For example, the new chief executive of MCI, which emerged from bankruptcy in April, has begun altering the company's culture and reputation, in part by identifying integrity and ethics as top priorities. After the company was cited by the federal government in July for a weak ethics program and lax accounting controls and thus prohibited from bidding on government contracts, MCI appointed a chief ethics officer who reports directly to the chief executive. In addition, the chief executive articulated ten "guiding principles," including "uphold the law" and "avoid conflicts of interest," that are printed on posters and displayed in company headquarters. All 55,000 employees recently completed a one-hour computer course in business ethics.

MCI is among a burgeoning number of companies, such as General Motors Corp., General Electric Co., and Waste Management Inc., which have elevated the status of ethics within the corporate culture by hiring ethics professionals. The Ethics Officer Association was established in 1992 with just 10 members but now claims more than 1,000. At least half of the Fortune 100 companies are represented, as are other organizations such as the New York Stock Exchange, the Securities Industry Association, and non-profit groups and municipal governments.

As encouraging as this development seems, an ethics office in and of itself cannot guarantee ethical behavior by employees. Strong and focused leadership by top executives is the first prerequisite. Beyond that, specific steps to instill the organizational culture with a commitment to upright conduct and a means of enforcing that expectation are mandatory. Some organizations may find this transition easier than others will. But a tough challenge is no excuse for inaction. Ethical leadership in the corporate community is a public policy concern that merits executives' full attention; anything less would be a disservice to our society.

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