

# Harvard Business Review



FAILURE: UNDERSTAND IT

## Ethical Breakdowns

**Good people often let bad things happen. Why?**

*by Max H. Bazerman and Ann E. Tenbrunsel*

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# Ethical Breakdowns

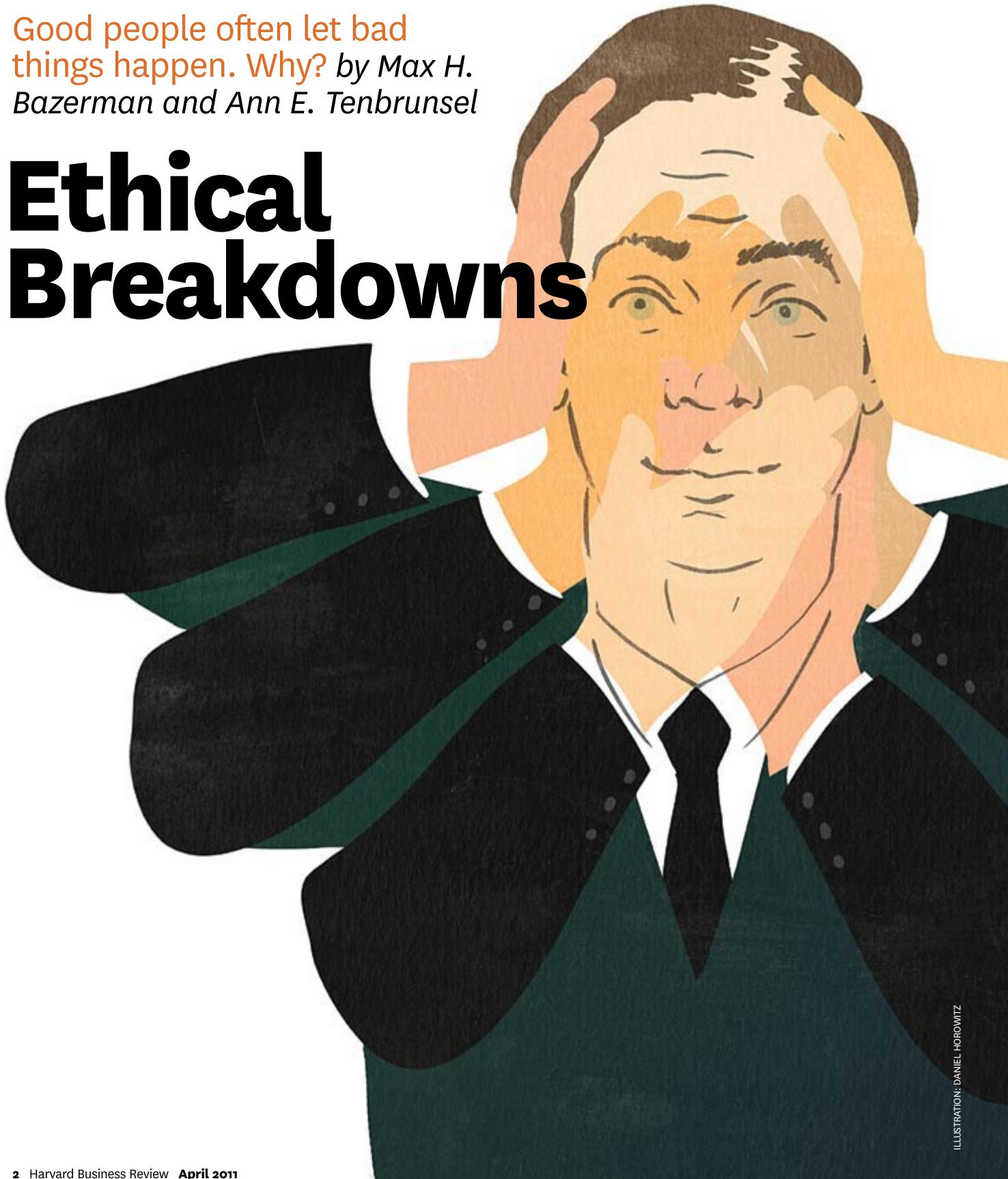


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**THE VAST MAJORITY** of managers mean to run ethical organizations, yet corporate corruption is widespread. Part of the problem, of course, is that some leaders are out-and-out crooks, and they direct the malfeasance from the top. But that is rare. Much more often, we believe, employees bend or break ethics rules because those in charge are blind to unethical behavior and may even unknowingly encourage it.

Consider an infamous case that, when it broke, had all the earmarks of conscious top-down corruption. The Ford Pinto, a compact car produced during the 1970s, became notorious for its tendency in rear-end collisions to leak fuel and explode into flames. More than two dozen people were killed or injured in Pinto fires before the company issued a recall to correct the problem. Scrutiny of the decision process behind the model's launch revealed that under intense competition from Volkswagen and other small-car manufacturers, Ford had rushed the Pinto into production. Engineers had discovered the potential danger of ruptured fuel tanks in preproduction crash tests, but the assembly line was ready to go, and the company's leaders decided to proceed. Many saw the decision as evidence of the callousness, greed, and mendacity of Ford's leaders—in short, their deep unethicality.

But looking at their decision through a modern lens—one that takes into account a growing understanding of how cognitive biases distort ethical decision making—we come to a different conclusion. We suspect that few if any of the executives involved in the Pinto decision believed that they were making an unethical choice. Why? Apparently because they thought of it as purely a business decision rather than an ethical one.

Taking an approach heralded as rational in most business school curricula, they conducted a formal cost-benefit analysis—putting dollar amounts on a redesign, potential lawsuits, and even lives—and determined that it would be cheaper to pay off lawsuits than to make the repair. That methodical process colored how they viewed and made their choice. The moral dimension was not part of the equation. Such “ethical fading,” a phenomenon first described by Ann Tenbrunsel and her colleague David Messick, takes ethics out of consideration and even increases unconscious unethical behavior.

What about Lee Iacocca, then a Ford executive VP who was closely involved in the Pinto launch? When the potentially dangerous design flaw was first discovered, did anyone tell him? “Hell no,” said one high company official who worked on the Pinto, according to a 1977 article in *Mother Jones*. “That person would have been fired. Safety wasn’t a popular subject around Ford in those days. With Lee it was taboo.

## FOCUS ON FAILURE



**My life has been nothing but a failure, and all that's left for me to do is to destroy my paintings before I disappear."**

**CLAUDE MONET**  
PAINTER



Whenever a problem was raised that meant a delay on the Pinto, Lee would chomp on his cigar, look out the window and say ‘Read the product objectives and get back to work.’”

We don’t believe that either Iacocca or the executives in charge of the Pinto were consciously unethical or that they intentionally sanctioned unethical behavior by people further down the chain of command. The decades since the Pinto case have allowed us to dissect Ford’s decision-making process and apply the latest behavioral ethics theory to it. We believe that the patterns evident there continue to recur in organizations. A host of psychological and organizational factors diverted the Ford executives’ attention from the ethical dimensions of the problem, and executives today are swayed by similar

rather than profits. The lesson is clear: When employees behave in undesirable ways, it’s a good idea to look at what you’re encouraging them to do. Consider what happened at Sears, Roebuck in the 1990s, when management gave automotive mechanics a sales goal of \$147 an hour—presumably to increase the speed of repairs. Rather than work faster, however, employees met the goal by overcharging for their services and “repairing” things that weren’t broken.

Sears is certainly not unique. The pressure at accounting, consulting, and law firms to maximize billable hours creates similarly perverse incentives. Employees engage in unnecessary and expensive projects and creative bookkeeping to reach their goals. Many law firms, increasingly aware that goals are driving some unethical billing practices, have made billing more transparent to encourage honest reporting. Of course, this requires a detailed allotment of time spent, so some firms have assigned codes to hundreds of specific activities. What is the effect? Deciding where in a multitude of categories an activity falls and assigning a precise number of minutes to it involves some guesswork—which becomes a component of the billable hour. Research shows that as the uncertainty involved in completing a task increases, the guesswork becomes more unconsciously self-serving. Even without an intention to pad hours, overbilling is the outcome. A system designed to promote ethical behavior backfires.

**It’s a good idea to look at what you’re encouraging employees to do. A sales goal of \$147 an hour led auto mechanics to “repair” things that weren’t broken.**

forces. However, few grasp how their own cognitive biases and the incentive systems they create can conspire to negatively skew behavior and obscure it from view. Only by understanding these influences can leaders create the ethical organizations they aspire to run.

### ILL-Conceived Goals

In our teaching we often deal with sales executives. By far the most common problem they report is that their sales forces maximize sales rather than profits. We ask them what incentives they give their salespeople, and they confess to actually rewarding sales

Let’s look at another case in which a well-intentioned goal led to unethical behavior, this time helping to drive the recent financial crisis. At the heart of the problem was President Bill Clinton’s desire to increase homeownership. In 2008 the *BusinessWeek* editor Peter Coy wrote:

Add President Clinton to the long list of people who deserve a share of the blame for the housing bubble and bust. A recently re-exposed document shows that his administration went to ridiculous lengths to increase the national homeownership rate. It promoted paper-thin down payments and pushed for ways to get lenders to give mortgage

**Idea in Brief**

Companies have poured time and money into ethics training and compliance programs, but unethical behavior in business is nevertheless widespread. That's because cognitive biases and organizational systems blind managers to unethical behavior, whether their own or that of others.

**All these serve to derail even the best-intentioned managers:**

- Goals that reward unethical behavior
- Conflicts of interest that motivate people to ignore bad behavior when they have something to lose by recognizing it
- A tendency to overlook dirty work that's been outsourced to others
- An inability to notice when behavior deteriorates gradually
- A tendency to overlook unethical decisions when the outcome is good

Surveillance and sanctioning systems won't work by themselves to improve the ethics of your organization. You must be aware of these biases and incentives and carefully consider the ethical implications of every decision.

loans to first-time buyers with shaky financing and incomes. It's clear now that the erosion of lending standards pushed prices up by increasing demand, and later led to waves of defaults by people who never should have bought a home in the first place.

The Sears executives seeking to boost repair rates, the partners devising billing policies at law firms, and the Clinton administration officials intending to increase homeownership never meant to inspire unethical behavior. But by failing to consider the effects of the goals and reward systems they created, they did.

Part of the managerial challenge is that employees and organizations require goals in order to excel. Indeed, among the best-replicated results in research on managerial behavior is that providing specific, moderately difficult goals is more effective than vague exhortations to "do your best." But research also shows that rewarding employees for achieving narrow goals such as exact production quantities may encourage them to neglect other areas, take undesirable "ends justify the means" risks, or—most important from our perspective—engage in more unethical behavior than they would otherwise.

Leaders setting goals should take the perspective of those whose behavior they are trying to influence and think through their potential responses. This will help head off unintended consequences and prevent employees from overlooking alternative goals, such as honest reporting, that are just as important to reward if not more so. When leaders fail to meet this responsibility, they can be viewed as not only promoting unethical behavior but blindly engaging in it themselves.

**Motivated Blindness**

It's well documented that people see what they want to see and easily miss contradictory information when it's in their interest to remain ignorant—a psy-

chological phenomenon known as motivated blindness. This bias applies dramatically with respect to unethical behavior. At Ford the senior-most executives involved in the decision to rush the flawed Pinto into production not only seemed unable to clearly see the ethical dimensions of their own decision but failed to recognize the unethical behavior of the subordinates who implemented it.

Let's return to the 2008 financial collapse, in which motivated blindness contributed to some bad decision making. The "independent" credit rating agencies that famously gave AAA ratings to collateralized mortgage securities of demonstrably low quality helped build a house of cards that ultimately came crashing down, driving a wave of foreclosures that pushed thousands of people out of their homes. Why did the agencies vouch for those risky securities?

Part of the answer lies in powerful conflicts of interest that helped blind them to their own unethical behavior and that of the companies they rated. The agencies' purpose is to provide stakeholders with an objective determination of the creditworthiness of financial institutions and the debt instruments they sell. The largest agencies, Standard & Poor's, Moody's, and Fitch, were—and still are—paid by the companies they rate. These agencies made their profits by staying in the good graces of rated companies, not by providing the most accurate assessments of them, and the agency that was perceived to have the laxest rating standards had the best shot at winning new clients. Furthermore, the agencies provide consulting services to the same firms whose securities they rate.

Research reveals that motivated blindness can be just as pernicious in other domains. It suggests, for instance, that a hiring manager is less likely to notice ethical infractions by a new employee than are people who have no need to justify the hire—

particularly when the infractions help the employee's performance. (We've personally heard many executives describe this phenomenon.) The manager may either not see the behavior at all or quickly explain away any hint of a problem.

Consider the world of sports. In 2007 Barry Bonds, an outfielder for the San Francisco Giants, surpassed Hank Aaron to become the all-time leader in career home runs—perhaps the most coveted status in Major League Baseball. (Bonds racked up 762 versus Aaron's 755.) Although it was well known that the use of performance-enhancing drugs was common in baseball, the Giants' management, the players' union, and other interested MLB groups failed to fully investigate the rapid changes in Bonds's physical appearance, enhanced strength, and dramatically increased power at the plate. Today Bonds stands accused of illegally using steroids and lying to a grand jury about it; his perjury trial is set for this spring. If steroid use did help bring the home runs that swelled ballpark attendance and profits, those with a stake in Bonds's performance had a powerful motivation to look the other way: They all stood to benefit financially.

## Managers routinely delegate unethical behaviors to others, and not always consciously.

It does little good to simply note that conflicts of interest exist in an organization. A decade of research shows that awareness of them doesn't necessarily reduce their untoward impact on decision making. Nor will integrity alone prevent them from spurring unethical behavior, because honest people can suffer from motivated blindness. Executives should be mindful that conflicts of interest are often not readily visible and should work to remove them from the organization entirely, looking particularly at existing incentive systems.

### Indirect Blindness

In August 2005 Merck sold off two cancer drugs, Mustargen and Cosmegen, to Ovation, a smaller pharmaceutical firm. The drugs were used by fewer than 5,000 patients and generated annual sales of only about \$1 million, so there appeared to be a clear logic to divesting them. But after selling the rights to manufacture and market the drugs to Ovation, Merck

continued to make Mustargen and Cosmegen on a contract basis. If small-market drugs weren't worth the effort, why did Merck keep producing them?

Soon after the deal was completed, Ovation raised Mustargen's wholesale price by about 1,000% and Cosmegen's even more. (In fact, Ovation had a history of buying and raising the prices on small-market drugs from large firms that would have had public-relations problems with conspicuous price increases.) Why didn't Merck retain ownership and raise the prices itself? We don't know for sure, but we assume that the company preferred a headline like "Merck Sells Two Products to Ovation" to one like "Merck Increases Cancer Drug Prices by 1,000%."

We are not concerned here with whether pharmaceutical companies are entitled to gigantic profit margins. Rather, we want to know why managers and consumers tend not to hold people and organizations accountable for unethical behavior carried out through third parties, even when the intent is clear. Assuming that Merck knew a tenfold price increase on a cancer drug would attract negative publicity, we believe most people would agree that using an intermediary to hide the increase was unethical. At the same time, we believe that the strategy worked because people have a cognitive bias that blinds them to the unethicability of outsourcing dirty work.

Consider an experiment devised by Max Bazerman and his colleagues that shows how such indirectness colors our perception of unethical behavior. The study participants read a story, inspired by the Merck case, that began this way: "A major pharmaceutical company, X, had a cancer drug that was minimally profitable. The fixed costs were high and the market was limited. But the patients who used the drug really needed it. The pharmaceutical was making the drug for \$2.50/pill (all costs included), and was only selling it for \$3/pill."

Then a subgroup of study participants was asked to assess the ethicality of "A: The major pharmaceutical firm raised the price of the drug from \$3/pill to \$9/pill," and another subgroup was asked to assess the ethicality of "B: The major pharmaceutical X sold the rights to a smaller pharmaceutical. In order to recoup costs, company Y increased the price of the drug to \$15/pill."

Participants who read version A, in which company X itself raised the price, judged the company more harshly than did those who read version B, even though the patients in that version ended up paying more. We asked a third subgroup to read both versions and judge which scenario was more

# Five Barriers to an Ethical Organization

Even the best-intentioned executives are often unaware of their own or their employees' unethical behavior. Here are some of the reasons—and what to do about them.

DESCRIPTION	ILL-CONCEIVED GOALS	MOTIVATED BLINDNESS	INDIRECT BLINDNESS	THE SLIPPERY SLOPE	OVERVALUING OUTCOMES
EXAMPLE	We set goals and incentives to promote a desired behavior, but they encourage a negative one.	We overlook the unethical behavior of others when it's in our interest to remain ignorant.	We hold others less accountable for unethical behavior when it's carried out through third parties.	We are less able to see others' unethical behavior when it develops gradually.	We give a pass to unethical behavior if the outcome is good.
REMEDIES	The pressure to maximize billable hours in accounting, consulting, and law firms leads to unconscious padding.	Baseball officials failed to notice they'd created conditions that encouraged steroid use.	A drug company deflects attention from a price increase by selling rights to another company, which imposes the increase.	Auditors may be more likely to accept a client firm's questionable financial statements if infractions have accrued over time.	A researcher whose fraudulent clinical trial saves lives is considered more ethical than one whose fraudulent trial leads to deaths.

unethical. Those people saw company X's behavior as less ethical in version B than in version A. Further experiments using different stories from inside and outside business revealed the same general pattern: Participants judging on the basis of just one scenario rated actors more harshly when they carried out an ethically questionable action themselves (directly) than when they used an intermediary (indirectly). But participants who compared a direct and an indirect action based their assessment on the outcome.

These experiments suggest that we are instinctively more lenient in our judgment of a person or an organization when an unethical action has been delegated to a third party—particularly when we have incomplete information about the effects of the outsourcing. But the results also reveal that when we're presented with complete information and reflect on it, we can overcome such "indirect blindness" and see unethical actions—and actors—for what they are.

Managers routinely delegate unethical behaviors to others, and not always consciously. They may tell subordinates, or agents such as lawyers and accountants, to "do whatever it takes" to achieve some goal, all but inviting questionable tactics. For example, many organizations outsource production to countries with lower costs, often by hiring another company to do the manufacturing. But the offshore

manufacturer frequently has lower labor, environmental, and safety standards.

When an executive hands off work to anyone else, it is that executive's responsibility to take ownership of the assignment's ethical implications and be alert to the indirect blindness that can obscure unethical behavior. Executives should ask, "When other people or organizations do work for me, am I creating an environment that increases the likelihood of unethical actions?"

## The Slippery Slope

You've probably heard that if you place a frog in a pot of boiling water, the frog will jump out. But if you put it in a pot of warm water and raise the temperature gradually, the frog will not react to the slow change and will cook to death. Neither scenario is correct, but they make a fine analogy for our failure to notice the gradual erosion of others' ethical standards. If we find minor infractions acceptable, research suggests, we are likely to accept increasingly major infractions as long as each violation is only incrementally more serious than the preceding one.

Bazerman and the Harvard Business School professor Francesca Gino explored this in an experiment in which the participants—"auditors"—were asked to decide whether to approve guesses provided by "estimators" of the amount of money in jars. The



## Rewarding unethical decisions because they have good outcomes is a recipe for disaster over the long term.

auditors could earn a percentage of a jar's contents each time they approved an estimator's guess—and thus had an incentive to approve high estimates—but if they were caught approving an exaggerated estimate, they'd be fined \$5. Over the course of 16 rounds, the estimates rose to suspiciously high levels either incrementally or abruptly; all of them finished at the same high level. The researchers found that auditors were twice as likely to approve the high final estimates if they'd been arrived at through small incremental increases. The slippery-slope change blinded them to the estimators' dishonesty.

Now imagine an accountant who is in charge of auditing a large company. For many years the client's financial statements are clean. In the first of two scenarios, the company then commits some clear transgressions in its financial statements, even breaking the law in certain areas. In the second scenario, the auditor notices that the company stretched but did not appear to break the law in a few areas. The next year the company's accounting is worse and includes a minor violation of federal accounting standards. By the third year the violation has become more severe. In the fourth year the client commits the same clear transgressions as in the first scenario.

The auditors-and-estimators experiment, along with numerous similar ones by other researchers, suggest that the accountant above would be more likely to reject the financial statements in the first scenario. Bazerman and colleagues explored this effect in depth in "Why Good Accountants Do Bad Audits" (HBR November 2002).

To avoid the slow emergence of unethical behavior, managers should be on heightened alert for even trivial-seeming infractions and address them immediately. They should investigate whether there has been a change in behavior over time. And if something seems amiss, they should consider inviting a colleague to take a look at all the relevant data and evidence together—in effect creating an "abrupt" experience, and therefore a clearer analysis, of the ethics infraction.

### **Overvaluing Outcomes**

Many managers are guilty of rewarding results rather than high-quality decisions. An employee may make a poor decision that turns out well and be rewarded for it, or a good decision that turns out poorly and be punished. Rewarding unethical decisions because they have good outcomes is a recipe for disaster over the long term.

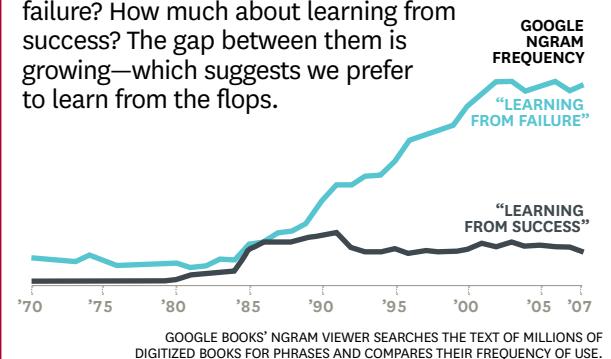
The Harvard psychologist Fiery Cushman and his colleagues tell the story of two quick-tempered brothers, Jon and Matt, neither of whom has a criminal record. A man insults their family. Jon wants to kill the guy: He pulls out and fires a gun but misses, and the target is unharmed. Matt wants only to scare the man but accidentally shoots and kills him. In the United States and many other countries, Matt can expect a far more serious penalty than Jon. It is clear that laws often punish bad outcomes more aggressively than bad intentions.

Bazerman's research with Francesca Gino and Don Moore, of Carnegie Mellon University, high-

## FOCUS ON FAILURE

### SCHOOL OF HARD KNOCKS

How much do we talk about learning from failure? How much about learning from success? The gap between them is growing—which suggests we prefer to learn from the flops.



lights people's inclination to judge actions on the basis of whether harm follows rather than on their actual ethicality. We presented the following stories to two groups of participants.

Both stories begin: "A pharmaceutical researcher defines a clear protocol for determining whether or not to include clinical patients as data points in a study. He is running short of time to collect sufficient data points for his study within an important budgetary cycle in his firm."

Story A continues: "As the deadline approaches, he notices that four subjects were withdrawn from the analysis due to technicalities. He believes that the data in fact are appropriate to use, and when he adds those data points, the results move from not quite statistically significant to significant. He adds these data points, and soon the drug goes to market. This drug is later withdrawn from the market after it kills six patients and injures hundreds of others."

Story B continues: "He believes that the product is safe and effective. As the deadline approaches, he notices that if he had four more data points for how subjects are likely to behave, the analysis would be significant. He makes up these data points, and soon the drug goes to market. This drug is a profitable and effective drug, and years later shows no significant side effects."

After participants read one or the other story, we asked them, "How unethical do you view the researcher to be?" Those who read story A were much more critical of the researcher than were those who read story B, and felt that he should be punished more harshly. Yet as we see it, the researcher's behavior was more unethical in story B than in story A. And that is how other study participants saw it when we removed the last sentence—the outcome—from each story.

Managers can make the same kind of judgment mistake, overlooking unethical behaviors when outcomes are good and unconsciously helping to undermine the ethicality of their organizations. They should beware this bias, examine the behaviors that drive good outcomes, and reward quality decisions, not just results.

### The Managerial Challenge

Companies are putting a great deal of energy into efforts to improve their ethicality—installing codes of ethics, ethics training, compliance programs, and in-house watchdogs. Initiatives like these don't

come cheap. A recent survey of 217 large companies indicated that for every billion dollars of revenue, a company spends, on average, \$1 million on compliance initiatives. If these efforts worked, one might argue that the money—a drop in the bucket for many organizations—was well spent. But that's a big if. Despite all the time and money that have gone toward these efforts, and all the laws and regulations that have been enacted, observed unethical behavior is on the rise.

This is disappointing but unsurprising. Even the best-intentioned ethics programs will fail if they don't take into account the biases that can blind us to unethical behavior, whether ours or that of others. What can you do to head off rather than exacerbate unethical behavior in your organization? Avoid "forcing" ethics through surveillance and sanctioning systems. Instead ensure that managers and employees are aware of the biases that can lead to unethical behavior. (This simple step might have headed off the disastrous decisions Ford managers made—and employees obeyed—in the Pinto case.) And encourage your staff to ask this important question when considering various options: "What ethical implications might arise from this decision?"

Above all, be aware as a leader of your own blind spots, which may permit, or even encourage, the unethical behaviors you are trying to extinguish. □

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