1

THE TIPPING POINT: HOW GOOD COMPANIES GO BAD AND EXECUTIVES BECOME ROGUES

Through the 1990s, most Americans grew accustomed to good financial news. We enjoyed one of the highest standards of living in the world, a product of the dynamism of our business system. Keen competition combined with the driving force of good management efficiently provided a constant flow of new and better products and services. Our free enterprise, management styles, education, and executives were all being copied—the envy of the world. Americans felt proud of the unusual degree of peace and prosperity free market capitalism had provided.

Pride so easily tips into arrogance and prosperity into greed. With the new millennium came startling revelations of destructive cracks in our much-heralded enterprise systems. In the years following, large numbers of Americans began to lose faith in the integrity of business and its leaders. A small cadre of executives were exploiting their positions to "hog" corporate profits with unconscionable pay packages and breaking the law in the bargain.

Business scandals are just another part of the stream of daily news that is full of scandal. The wars in the Middle East bring stories of prisoner-of-war torture and war profiteering. Our all-American pastime, baseball, is scandalized by revelations of steroid use. America's Catholic Church sex scandal has been in the news off and on for several years.

The media confesses to its own scandals, inflated circulation numbers, made up stories, and shilling for politicians. School administrators and teachers are caught helping students cheat on proficiency tests and fudging their books to make dropout rates appear lower.

Americans are still learning about new and troublesome examples of self-aggrandizing executives and misconduct in American business a full five years after the first publicized revelations that all was not well in corporate America. Even as these stories continue breaking, the financial news suggests that senior executive compensation is still increasing, often providing eight-figure annual earnings.

Headlines Just Keep Coming…

Here is a just a handful of disturbing financial stories reported in the final days of 2004 and early 2005:

- The CEO of America's largest insurance broker, Marsh & McLennan, resigned under pressure. His company is alleged to have engaged in bid rigging and secretly restricting clients' choice of carriers to those paying extra commissions. It is also alleged that the CEO and several other senior executives are involved in unrevealed partnerships that acquired ownership interests in other insurance companies.
- A number of CitiGroup's Japanese-based bankers have been fired after the firm was barred from engaging in private banking in Japan for some unspecified time. The Japanese government accuses Citi of tolerating deceptive marketing practices and providing channels that could be used for money laundering for high-income Japanese.
- The top two executives of Fannie Mae are out. America's largest and formerly highly respected, government-backed corporation supporting the market for residential mortgages was engulfed in scandal. A federal review of its accounting disclosed accounting irregularities that require a $9 billion restatement. Investigations are probing

whether accounting manipulations were done for the sake of executives gaining substantial bonuses.

- Time Warner is having to revise its financial statements to reflect AOL's misstatements of revenues.
- American International Group (AIG), one of the largest insurance companies in the world and formerly one of America's most highly regarded public companies, has had to admit that its accounting may have been misleading to investors. It used a variety of complex financial instruments and partially owned off shore reinsurance companies to "smooth earnings" and increase reported reserves.[1] At the same time, serious questions have been raised about some transactions of Warren Buffet's Berkshire Hathaway's subsidiary, General Re. As with AIG, these are alleged to have been conducted to accomplish an accounting effect.

It is no longer just the risky dotcoms and their high-tech brethren who get in trouble. The diversity and prestige of corporations in the news suggest there are some underlying forces affecting a broad swath of business. Americans should be concerned that many executives are still tempted to engage in or encourage actions that show this new, troubled face of free enterprise.

We have sought to step back from the headlines and salacious details. Our studies disclose a number of destructive distortions in the components of our business system that together over the past decade have conspired to produce the distressing headlines about accounting irregularities, fraud, and the tales of exorbitant executive compensation. Understanding what has been going wrong and how it can be checked and reversed requires going behind the bad guy stories to a view of how the parts fit together and play off of each other.

Remember, America in the 1990s was pulsing with the easy profits of a new gold rush. Investors shoved to get in on the ground floor of new industries and new marketing ploys—just before they tanked into a

subbasement. As shareholders and employees began experiencing enormous losses, CEO celebrities became villains.

At first, it was easy to assume that the Enron implosion and the uncounted number of dotcom failures were anomalies. They represented an inflammatory mixture of some truly rotten apples combined with wild shareholder exuberance and investment analyst and entrepreneurial excess. The half a decade following proved this view too optimistic. As we tip into the last half of the first decade of a new millennium, we look for signs of real change. (One hopes that the popularity of Donald Trump's television show, *The Apprentice*, is not a reflection of reality or being mistaken for a model to emulate.)

In the extraordinarily tough global economy, America can't afford economic vulnerabilities and weakness. We are no longer the unchallenged market leader in many industries, and competition gets tougher by the day. Manufacturing is fast becoming an endangered species in the U.S., and even our mainstay, financial services, is outsourcing some functions overseas.

We expect that free enterprise capitalism combines the self-regulation of the marketplace with powerful motivations for ambitious entrepreneurs and talented executives. Enormous energy and creativity is released in a free capitalist society. Overpriced or poor quality goods or services, outdated technologies, defective business plans, and ineffectual managements and companies—all get rejected (in time) by market forces.

As in much of life, there are "snakes" in the garden. Embedded in this marvelous, self-managing, self-cleansing motivational engine that generates innovation and growth is the potential for exploitation and cheating. We've known this. The real work has always been in keeping the proportion of such incidents low.

In the past, some American business tycoons sought to "beat the system" by anti-competitive maneuverings in the marketplace. Many presumably free markets became manipulated markets. While business executives universally professed allegiance to free enterprise, it was often expedient for some corporations to engage in collusive price fixing and dividing up the market with like-minded competitors. These

market-manipulating executives always professed more loyalty to free enterprise than to free markets. Monopolies provide easier and greater profitability. Our effective anti-trust legislation, when enforced, is a testament to the strength of these lurking temptations and the need for some government intervention.

Today, the Inner Dynamics of Business Are the Culprits

Today's threats to American capitalism are primarily *internal* to the corporation, very different from efforts to monopolize external markets.

Management has been changing, not always for the better. The change started with modest deviations from accepted good accounting practice, pushing the limits, such as not expensing stock options. When no resistance was forthcoming, sophisticated number games and executive self-serving became a ground swell of malfeasance. Modest dithering with the accounting tipped over into flagrant fraud. For example, technically, Enron had been bankrupt for years before its bankruptcy filing in December 2001. As we shall see, many other companies were running on fumes generated by financial engineering.

When chief financial officers privately asked the head of the Security and Exchange Commission (SEC) to make rules harder so it would be easier for them to resist the orders of their CEOs, it became obvious that some things needed to change in the 1990s.[1] They didn't, and Americans paid a heavy price.

Concurrently, executive compensation became obscene, scandalizing Europeans who saw their executives adopting American values. Top management can be earning 1,000 times the average worker's pay versus 50 or 100 times not so long ago, if American trends are followed. More extraordinary and more troubling, executive pay is taking a significant bite out of the net earnings of many companies—10% of the shareholder's stake in one study![2]

It appeared that the system had been rigged to favor the very few on top. They had become the beneficiaries of corporate largess, reflecting

what appeared to be soaring profitability or shareholder value. We learned too late that many executive performance measures were hollow successes, highly rewarding to executives and short-lived for employees and investors. For many companies, reported earnings were more myth than reality.

These changes in executive values and decision making have consequences more serious than the loss of investor confidence and portfolio profits. What has emerged threatens the future vitality and global competitiveness of their companies. Chapters to follow look closely at the major players in this flight from excellence. Included, of course, are senior executives, corporate boards, auditors, investment bankers, and the investor community. It is also important to understand why business journalists were so slow to spot corporate deception and executive fraud, and business academics and consultants so slow to spot the failure of theories.

The following is a preview of the major forces that led to the misshaping of executive decision making and many high cost failures—to employees and investors, not executives.

Individualism Run Amok

Americans are justly proud of our individualism. It is a bedrock societal value, and it has contributed to our economic growth and our freedom. But there can be too much of a good thing. Americans are notorious for believing that if a little is good, a lot is better. We often learn lessons the hard way, by tending toward excess. This has happened in the case of our idealization of individualism.

Many profligate executives display a perverted individualism. They are narcissists who have an excessive sense of personal entitlement, demanding egregiously high compensation packages, adorned with every conceivable perquisite. These executives reveal a desire to have it *all* now believing they are worth it, no matter how outrageous "it" is.

Such corporate leaders have become obsessed with personal wealth building and the financial well being of their family and future generations. Exhibitionism is no longer perceived as the poor taste of the

nouveau riche. It is telling the world that you are a great success and worthy of celebrity status. There is little evidence the trend is abating.

A threatening side effect of skyrocketing executive salaries is the pain caused to the tax-supported public sector. A mid-sized city's Head Start program director paying himself over $800,000 in a three-year period is an example. The tide of rising corporate executive earnings lifted the boats of all types of executives.

Celebrities have deferential subordinates and media attention, which build the sense of entitlement. Entitlement means never having to feel embarrassed by bestowing upon yourself costly New York City pads and GulfStream jets as well as unconscionable monetary rewards. And never having to say you're sorry because there may be no relationship between the size of your executive bonus and real corporate performance.

Two law professors explode the myth that excessively high executive earnings have something to do with exceptional performance.[3] Instead of pay relating to performance, their findings show the weakness or indifference of boards of directors, the subject of Chapter 7, "Directors: Why the Weak Oversight."

Designing lucrative, complex compensation agreements, astute management of option grants, overseeing carefully arranged option execution, and accumulating as much personal wealth as possible, have become major distractions from the business of running a company for some top executives. Energies are siphoned off to exploit "insider trader" advantages. Big option grants and share sales are fine tuned to coordinate with the release to the press of both good and bad corporate news.

A couple of examples suggest the severity of the compensation problem. The CEO of Global Crossing managed to convert options to stock to cash to the tune of three quarters of a billion dollars very shortly before the company imploded. One year, several of Computer Associates' top executives are alleged to have shared a bonus of a billion dollars based on earnings inflated by cooking the books.

Severance payments are perhaps the most obvious indicator of the heights (or depths) of this new age executive greed. Severance had legitimate origins. Shareholders were concerned that attractive acquisition offers would be ignored by executives wishing to retain their high paying positions. Thus, the promise of a kind of insurance. Lose your job and you get some payout.

Pure greed took over when companies started paying for non-service. Severance often now comes without a change in ownership, just departing. Thirty to 50 million dollars and more is not unusual severance, and the infamous examples are over a hundred million. Often, these payments are made after relatively short service and regardless of whether or not performance was considered good or even acceptable. Michael Ovitz, former president of Disney Co., is a prime example. He received $140 million in severance payouts after only a 14-month tenure. Shareholders brought a lawsuit, which is still not resolved seven years later. Meanwhile, Ovitz has control over the money. There are plenty of examples, such as Carly Fiorina, Hewlett-Packard's CEO, who was asked to resign rather than being fired, so she collected her multi-million dollar payout.

Almost forgotten are the traditional expectations of executives: after two or three decades of service and reasonable salaries, a good pension to make for a comfortable retirement. It was taken for granted that executives looked to the future. They made sacrifices today for tomorrow's rewards and the tomorrows were measured in decades.

By way of contrast, a recent report notes that executives who might have earned hundreds of millions during their tenure were also likely to retire with annual pensions of at least a million dollars, and often significantly more.[4]

Diminished Sense of Personal Responsibility

Retaining or improving one's status and its associated remuneration has become the primary goal. Professionals, as well as executives, seem to have lost their sense of responsibility to the company and shareholders and to uphold the standards of their fields or disciplines. Boards of

directors, corporate counsels, and auditors often appear caught up in the same "me first" drive as executives. Professionals countenanced incredible departures from "good" corporate practice and accepted standards in order to share some of the largesse. Apparently, their consciences rested easily with the knowledge that "everyone" was doing it. Any latent anxieties were reduced by the knowledge that they were insulated by their company's liability policies.

Investment bankers, at least until recently, seem to have felt no qualms about selling "damaged goods," no concerns that their reputations as trusted bankers would be sullied. The financial news featured the lives and times of senior executives who apparently felt no pangs of conscience when they treated shareholder funds as their personal piggy bank.

Social critics bemoan such examples reflecting a culture that does not encourage personal responsibility and accountability. Social norms, the rules of proper conduct, the distinction between right and wrong have all become ambiguous and less constraining in twenty-first century America.

In part, this may reflect the growing discrepancy between risk and reward. At least until recently, executives who crossed the line in their managerial decision making in order to pump up company earnings, and therefore the value of this year's bonus and stock options, were unlikely to face serious penalties.

Emphasis On the Short, Short Run in Companies

Going up the management hierarchy always meant having a longer time horizon. Economists took for granted that top management would seek to grow the business and to build robust organizations with solid reputations that could weather the inevitable vicissitudes of the real world and gradually grow their earnings and dividends. By definition, top management took a long run view of strategic decision making.

Management strategy and decision making has been transformed in many companies. Very short-run thinking replaced those longer time horizons and tough tradeoffs among goals and "stakeholders." What

counts is this quarter's earnings or revenues and how they will compare with this period's earnings' "guidance" previously provided to "The Street." It was only the short-run "bottom line" that was pursued with a vengeance.

CEOs themselves also became short run. This has major consequences for the executive's time horizon. A half-dozen years in the job is becoming typical in contrast to the traditional assumption of service through retirement. Careerist job-hopping is one reason, but also there are the terminations following anemic share price growth.

Investor Impatience

Not many years ago, most shares were held by what we called "investors," whose objective was long-run growth in share price and steady dividends. Of less consequence were traders, who played the market for very short-term profits. Increasingly, the distinction has disappeared. Pension funds seeking better returns and the enormous numbers of new shareholders expecting rapid growth of their share prices have transformed the stock market. Pressure for continuous growth in share price has become focused on quarterly shareholder value that may not even be tied to real income or earnings. "Good" companies must have predictable and regular increases in their bottom line. What should be normal, good and bad surprises, good and bad quarters or even years, came to be viewed as indicators of a very poor investment.

Many CEOs have rebalanced their priorities. They devote substantial attention to their company's share price. Getting or maintaining personal prestige is part of the motivation, perceiving stock price as a measure of executive success. (Of course, as noted, stock prices directly relate to the size of the small fortunes that may be locked up in options.)

Finance and Accounting Assume a Central Role

The role and status of the finance and accounting functions of business have been enhanced in this new stock market. In many companies, the ability to manipulate numbers, income statements, and balance sheets is as, if not more, important than the ability to produce goods and services and being competitive in the marketplace. These corporate specialists, working closely with their outside counterparts—the auditors and the investment bankers—became the Brahmins of the company. Incredibly, in some companies, like Enron, accounting and finance became profit centers.

Naïve observers of business thought that accounting was simply a straightforward system of recording and reporting the "facts." In the same vein, it was taken for granted that the finance specialists helped the company to manage its funds. They sought to help balance inflows of cash (from operations) with expenditures. When necessary, they were knowledgeable on how to use external funding sources, such as banks and capital markets, to supplement those generated by operations.

Imaginative new financial products enabled companies to hide debt and losses, even converting some into profits. A variety of creative techniques became available to "smooth earnings." Skinny profit years could be pumped up, and fat years could be slimmed down. Off-balance sheet special purpose entities and finite reinsurance could be used to hide financially embarrassing liabilities and losses from the average investor and even from many investment analysts and regulators.

Byzantine financial transactions, "financial engineering," having nothing to do with building the business became the vehicle for "cooking the books." Both the profit and loss statement and the balance sheet and their accompanying notes had become less transparent. They had become another form of advertising.

What started as legitimate, modest massaging of the numbers to hit a bonus target or satisfy stock market analysts gradually became bolder and more deceptive. "Creative" new age approaches to accounting and the use of derivatives allowed top management to manipulate the apparent performance of their companies. Reported profitability and

corporate financial soundness were often the product of the risk tolerance and creativity of these paired money and numbers managers—finance and accounting.

Some accounting shenanigans were foolish in the extreme: A major software company, Computer Associates, allegedly added the value of new contracts that were signed in the next year to the previous year's income. Of course, the result was that the following year was missing the income from those contracts for year-end financial reporting. So it became necessary to manipulate the contract dates again. The process was repeated year after year—stealing income from a succession of years. In fact, nothing was being gained. The accounting deceptions were eventually uncovered, resulting in a costly prosecution.

Wheeling and Dealing

Mergers and acquisitions can make strategic sense for many companies: obtaining a new technology, filling out a product portfolio, gaining access to a new market, spreading overhead, and getting additional economies of scale, for example. But they can also be a tempting quick and easy way to improve the company's appearance.

Greater size equates with justifying higher top-management compensation. Many of these business combinations also allow a company to show almost immediate increases in revenue or earnings. This kind of revenue or earnings comes more easily and much more quickly than squeezing greater profitability out of "growing the business" and finding ways to increase productivity. Mergers and acquisitions also became another personal revenue stream for executives, who often made millions for themselves upon closing these deals.

Many of the world-class corporate scandals and bankruptcies of recent years were in companies that appeared to demonstrate extraordinary growth but had little operational follow through. Two of the more obvious are Enron and WorldCom. For all its glamour and apparent growth, Enron was never able to run anything that was really profitable, and WorldCom had a reputation for poor performance. WorldCom

and Enron, like many companies that had rapidly blown through many acquisitions, had enormous problems integrating them into their business operations.

Neglecting the Heart of the Business

To see how dealing and financial machinations trumped building the business, look closely at how the customer is treated.

The customer base is at the core of every company. Successful companies always seek to protect their reputation in the marketplace. Serving the customer's needs was an obvious component of almost every corporate decision. Loyal customers were a critical part of the company's "crown jewels" to be guarded at almost any cost.

In sharp contrast, it has become acceptable to deceive, even "con," the customer in some major companies. Again, the motivating force is obvious: the focus on short-term financial appearances and executive self-interest. The extremes of short-run thinking and the derogation of the customer may be an explanation of what otherwise is inexplicable.

There are horrific examples in recently exposed corporate transcripts and email of investment banking traders and stock analysts being derisive of their clients and taking pleasure in their deceptions and exploitation.[4] Some of the most obscene are the tapes of Enron trader phone conversations joking about the plight of "grandmas" during the California energy crisis. Investment analysts had no remorse when they recommend stocks to clients at the same time they bad mouthed them to colleagues, saying candidly that the stocks being pushed are dogs and likely to go belly up.

Management encouraged or countenanced self-destructive policies that must have looked good in the very short run but were devastating within a few short years. Surely, most readers of these widely published business stories must have asked themselves, "But how could they? What could management have been thinking?" The two corporate examples cited at the beginning of the chapter: CitiGroup (in Japan)

and Marsh & McLennan (with its bid rigging when its major clients sought new insurance) are almost unbelievable examples of mistreating your customers.

What Could Management Have Been Thinking?

Here is an example of executives "shooting themselves in the foot," deception and cheating that comes back to whack the originator:

- Numerous mutual funds destroyed their reputation by allowing a small number of investors to misuse the funds (by overnight trading and buying and selling at "stale" prices). Funds earned very modest extra management fees by granting these special privileges to hedge funds and a few "select" clients. Their corrupt trading and wrongful pricing cost the other 99% of the funds' investors dearly. When the corrupt practices were revealed, some funds lost half of the investors' money. In one case, the value of a fund family to its owners dropped half a billion dollars in a matter of weeks.

In broad segments of American business, disturbing conflicts of interest have been revealed in the last several years. Organizations entrusted with making certain purchases for clients have been shown to have investments in their preferred list of sources. In several well publicized cases, suppliers got on a preferred list by paying kickbacks. Such practices, of course, are familiar ways of doing business in less-developed parts of the world. Most of us presume we are a more advanced capitalist society.

Breaking the Cycle

As we have seen, there have been major changes in the decision calculus of an increasing number of executives. These began with fairly minor shifts in the trade offs and presumptions about what was proper and

what was questionable. Over the past decade, the choices of too many executives tipped over into the acceptance of deceit and corruption.

Corporate earnings were fictionalized, relying on deceptive accounting rather than marketplace performance. In some instances, reported earnings have become "designer" products, engineered to meet "The Street's" expectations or bonus hurdle levels. Worse yet, financial shamans have found ways to hide debt and dissemble the company's financial health. Incredibly, companies close to bankruptcy have been made to appear reasonably healthy to the dismay of even sophisticated investors and creditors. At the same time, executive compensation packages have gone over the top and miraculously continue to climb.

The widely observed changes in values and practices eat away and degrade the vitality of American business. In a tough global economy, a show and tell mentality won't "cut it" in the market place. Almost as scary, these trends undercut the reputation of American corporate executives and American capitalism, now dubbed by many foreigners as "predatory capitalism."

There is growing cynicism about top management's commitment to serving shareholders' interests versus their own. More critical books are appearing that question whether business goals are consistent with the values of American society. Americans traditionally espouse belief in fairness, candor, and honesty. Where scandals have been rampant, corporate values have shown themselves to be a shocking departure from these beliefs.

Many business leaders still seem insensitive to the widespread public resentment and cynicism surrounding "greedy executives," a term frequently used whenever the subject of business arises in everyday conversation. Public confidence in the financial system, in free enterprise, and in executive integrity is of incalculable value. If found too lacking, at some point, the political system will exact regulatory penalties.

But American business appears eager to forget and forgive the last five years. There is widespread grousing that the Sarbanes-Oxley Act of 2002 requires cumbersome and costly paperwork, and many suggest that procedures and parts of it need to be repealed. This major piece of federal legislation sought to deal with well-known sources of fraud and

deception. It was hastily enacted and may need some refinement, but it addressed some major issues effectively and should not be gutted.

Clearly, many corporations need to be more realistic about the seriousness of corporate misbehavior and learn how to attract, select, and compensate a quite different style of corporate leadership. (Something we shall discuss in Chapter 13.)

Change will not come easily. Contemporary American business culture provides a worrisome foundation for the excesses of executive behavior. Playing accounting games, conflicts of interest, and executive self dealing are now deeply embedded in the structure and values of many businesses, as well as their boards, bankers, and "flexible" auditors.

Change requires that both corporate boards and CEOs understand this and become committed to a new look in the executive suite. How to select executives who can practice a leadership style that builds businesses in contrast to engineered "bottom lines" is a tough challenge. Business itself and shareholders have much to gain by leaders committed to building robust and dynamic organizations and staying within both the spirit and letter of the rules. Fortunately, we have no reason to believe candidates are in short supply.

Private business is a major segment of American life. No fixed wall separates these economic institutions from our social and political life, our civic morale and morality. Regrettably, probably not in our lifetime, will senior corporate executives be perceived with the same respect and status they had before the new century began. America is a dynamic country; social and economic problems do get solved.