A Case Study Approach

BUSINESS ETHICS

Stephen K. Henn

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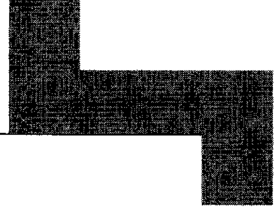

STEPHEN K. HENN

John Wiley & Sons, Inc.

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Henn, Stephen K., 1963-
Business ethics : a case study approach / Stephen K. Henn.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-470-45067-3 (cloth)
1. Business ethics–Case studies. I. Title.
HF5387.H4645 2009
174'.4—dc22

2009005649

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

Preface

What lies behind us and what lies before us are tiny matters compared to what lies within us.

—Ralph Waldo Emerson

January 1, 2009

When I set out to write a book about ethics in the summer months of 2008, I did not imagine what lay ahead for the world economy by year's end. The financial crisis, the seemingly intractable problems facing Detroit, the Bernie Madoff Ponzi scheme, the Siemens bribery scandal that resulted in an $800 million fine, and other developments have altered the business and economic landscape for the foreseeable future. Ethics seems to be discussed frequently when people talk about these matters. One hears "moral hazard" a lot. The substantive discussion, however, should be "Have we learned our lesson?" If the past few years are any guide, the answer is no.

In the seven years since Enron exploded, it seems little has changed. In the oft-cited *2007 National Business Ethics Survey,* the Ethics Resource Center observed corporate misbehavior is up since 2001. Despite all the words and regulations aimed at building ethical and responsible organizations, misbehavior has increased. As someone who has observed organizations' attempt to address corporate misconduct, this comes as no surprise. This is not to say corporate America is

inherently bad. It is not. And there has been progress. But three factors conspire to stifle it. First, during the post-Enron period, it took time to figure out what government regulators and the Department of Justice wanted. Unfortunately, whenever the government steps into the fray and declares its intent to use the power of the state to effect change, those potentially affected wait to see what the rules are going to be. Given what happened to Arthur Andersen because of its role in Enron, KPMG because of its sale of tax shelters, the effect of the McNulty memorandum on attorney-client privilege, and the like, just *what* appropriate action to take was unclear. Time and experience have provided some guidance. The Federal Sentencing Guidelines and the Committee of Sponsoring Organizations of the Treadway Commission—COSO—have provided an integrated framework, but not absolute assurance.

The second factor is what is meant by ethics. This question has two dimensions. The first relates to the natural feeling that all of us are ethical up to—and past—the point where we commit fraud. When the facts are all out, Bernie Madoff probably did not get up one morning and say, "Life is a bit too goody-goody for me. I think I'll run a Ponzi scheme and defraud investors of $50 billion, give or take." In the vast majority of cases, there is something small that starts to snowball. A corporation needs to cover a greater-than-expected loss, so it moves some money around and books some sketchy entries. The enabling lie is something to the effect of "We will be okay, because we will correct it next quarter." But things do not go well the next quarter and doubling down the next quarter only exacerbates the problem. The malfeasor is now stuck and either has to own up to the mistake or let it ride again . . . and again until the problem becomes too big and collapses under its own weight. Guilt can be like a ton of bricks and then some.

The second dimension is measurement. How do we measure the lack of ethics and how that may affect us one day? After all, are we not interested in the risk that something unethical can take place as well as whether our record is clean to date? Even if the defenses against fraud have protected the organization thus far, are they adequate to protect us in the future? Developing quantitative measures for qualitative data is

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never easy, but several methodologies have been developed to benchmark where an organization is and measure changes. As these tools become prevalent and accepted, standards can be developed for companies and organizations.

The final factor is the one that concerns us now. Too many organizations address the symptoms, not the disease. The chances for unethical behavior can be minimized with an understanding of why good people make bad ethical choices. An organization does not make mistakes; people within that organization do. Organizations do not commit fraud; people within that organization make the decision—alone or in concert—to commit fraud. In my experience, in today's politically correct world, not enough attention is paid to the individual choices people make within an organization. Yet in each case of corporate malfeasance, a point exists at which one or more individuals choose between doing the right thing or doing the wrong thing. In this book, we look at why individuals make the choices they do; what role the organization plays in their decision making, and what is the often misunderstood role of leadership in affecting behavior. I hope that by the last chapter you understand the background necessary to start developing specific action plans for your organization.

The Biggest Loser

As an ethics professional, I have much in common with a personal fitness trainer. This analogy works on many levels. While some clients are fit and trim from an ethical perspective, most organizations run the gamut from mildly to morbidly obese. To a personal trainer, weight loss is quite simple: Do you expend more calories than you consume? The physical formula is also simple: Reduce the calories you consume through diet and increase the calories you expend through exercise.

Of course, it is not that easy. Despite the inherent benefits of being fit, such as health and self-esteem, experience tells us that it is very difficult to battle the bulge. The biggest challenge to overcome is not opportunity, but mind-set. The secret to reducing weight lies in changing mental perceptions and attitude. Often it is phrased in terms

of altering your lifestyle. Get away from the things, situations, and people that cause you to overeat and neglect exercise. Break the bad habits and keep them broken. Quite frankly, most people would rather take a pill and be done with it. Dieting is no fun and exercise is hard, so do them tomorrow. Or you fool yourself into thinking one donut won't make a difference. Or you think, I have been good and I deserve a reward: Then you go to Starbucks—"One large Frappuccino, please." But your body cares only about the world as it is and not the world you wish for, so that Frappuccino will take about five miles of walking at a brisk pace, just to get back to even.

Creating an ethical organization faces similar hurdles. Too many organizations are looking for a quick solution, a "pill." Too many consultants are perfectly willing to sell an organization a bottle of Hoodia or other limited solution. ("Watch the pounds melt away in just five minutes a day! Guaranteed!") The result is that organizations are no better off than they were before Enron made "business ethics" an oxymoron.

Why You?

This is a book designed for senior leaders of organizations: boards, C-level executives, trustees, managing partners, government officials—anyone tasked with a duty, fiduciary or otherwise—to govern an organization. Of course, others should read it. The lessons learned here would not be lost on anyone, whether they are inside an organization or as an outside stakeholder. Nevertheless, I wrote this book to start a dialogue among senior leadership levels about the tactical issues relating to ethics and ethical behavior in organizations.

Further, this book is written with the assumption that you are concerned about the impact of ethical or unethical behavior on your organization. Some leaders do not see ethics as an important part of an organization's fabric, or they only care for image reasons. Commitment counts. Like it or not, your organization has a hypersensitive B.S. detector and any attempt to pretend ethics is important to the organization, but not to you, is doomed and may even backfire.

Employees in your organization follow leadership and can only be as serious about ethics as you are. Ethics for *thee*, but not for *me* is a recipe for failure.

This book is not simply about business or corporate ethics. There is no such distinction. There is "ethics" plain and simple. While we often talk about business ethics and business ethics is very much in the spotlight—ethical behavior is also an issue for professional firms such as accountants and lawyers, nonprofits, universities, and government, indeed anywhere large groups of individuals work toward a common goal. Therefore, we will discuss examples of malfeasance in a number of different contexts and business is only one of them.

This is not a survey book. While we look at history and several contextual case studies—positive and negative—germane to ethical behavior, we also discuss in depth how to approach and resolve specific ethical situations using the ideas in this book. We learn how to recognize warning signs and how to distinguish yellow flags from red.

Real organizations are dynamic and deep. Given the uniqueness of each organization, there is no simple checklist to determine the level of exposure your organization has to unethical behavior. This is not a how-to book. It is a set of tools to use your own judgment and understanding. Let's face it: You are where you are because something inside you has guided you along a successful path. This book focuses your attention on the key issues that underlie ethical and unethical behavior and provide you with the basic underpinnings to apply your judgment to each situation as it arises.

What Lies Ahead

This book gives both a theoretical and practical perspective on organizational ethics. Chapter 2 is a discussion on why business ethics is important. While "being good for goodness sake" is admirable, there is also growing empirical evidence that suggests organizations built on strong ethical foundations outperform organizations where ethics is not a principal business driver. Chapter 3 discusses why ethics is such an issue for all kinds of organizations—and not just businesses and

corporations—that are the subject of scrutiny. Chapter 4 gives a historical view of the evolution of ethics and how that has shaped our understanding of its importance in business.

The next three chapters discuss key elements involved in ethical and unethical behavior. Not every possible driver of human behavior is covered, but the focus here is on those most likely to impact your organization. Going to the notion of controllable versus uncontrollable risk, we look at the elements that are both controllable and common. Chapter 5 discusses the psychology behind individual decision making with an eye toward understanding both general moral development and specific stresses. Chapter 6 talks about the role that group behavior plays in affecting individual decision making and how to strengthen an individual's affinity for your organization. Chapter 7 is about leadership and the critical role leaders play in determining the culture of the organization.

Chapter 8 discusses the role of trust in an organization and its internal and external dealings. Chapters 9 through 11 discuss steps that can be taken to structurally reduce risk. First, how to minimize exposure, then how to create an environment that reinforces ethics, and finally the role of leadership—broadly defined—and how that impacts behavior.

Case studies in each chapter give basic facts germane to the discussion, followed by discussion. Some cases will be familiar and some will be new, but it is hoped that each will be meaningful. Finally, we discuss what would have been the right course of action, but depending on the objective, focusing on what were the warning signs and what was missing to allow for a better outcome.

Acknowledgments

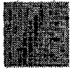
Talent wins games, but teamwork and intelligence win championships.

—MICHAEL JORDAN

While there is one name on the cover of this book, a number of people contributed to this book and made for a much better story. First, I would like to thank Anjali Gupta for her help and guidance. At critical points, when a push or research was needed, Anjali stepped up and provided help. I was lucky enough to have a tremendous team to help on researching case studies. In addition to Anjali, I would like to thank Katherine Liposky, Roberto Scalese, Prema Srivanasan, and Wendy Williams for their efforts in researching a number of the case studies. Anjali, Kat, Berto, Prema, and Wendy, with the contributions of Marni Centor and the invaluable assistance of Joyce Liposky, formed the "book club" that set the tone and approach as this project got off the ground.

Next, I would like to thank the staff at John Wiley & Sons, in particular Stacey Rivera, for their patience with me and the guidance I received.

Finally, this book would not have come about without the support of my wife Alison and my family. She serves as the moral leader of our family and I cannot find a better living example of integrity.



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CHAPTER 1

Introduction

To see what is in front of one's nose needs a constant struggle.

—GEORGE ORWELL

THEMES

So, with some niceties dispensed with, let's spend time on the overarching themes that you should keep in mind as we go through this discussion. The first is that your organization is not perfect, nor will it ever be. There will always be some risk involved. With employee turnover in the range of 10 to 20 percent per year, you will always be adding new dynamics to the mix of your personnel structure. This obvious fact goes to the point that you need to be looking at the ethical makeup of your organization constantly in the same manner and rigor you review financial performance.

So it is important to understand what you can control and what you cannot control. To keep it simple, there are three basic types of unethical behaviors. The first is the "lone wolf," that is, someone acting alone in a position of trust and in an area of their expertise. Embezzlement is typical of this problem. It is hard to stop the determined lone wolf. The good news is that the damage is *usually*

minimal. The slightly better news is that this unethical behavior is not "structural." It is the ethics equivalent of getting struck by lightning. Bad luck, but you move on. We will talk about ways—in the context of preventing more substantial problems—to minimize risk. A determined person, however, will be difficult to spot. That is, until they drive the $80,000 sports car to work.

The next type of unethical behavior is the "oops," which is far more common. This is where an employee—loyal, hardworking, and honest—makes a mistake. A big one. A mistake that could get him or her fired. The decision then, on that person's part, is to fess-up or cover-up. The overwhelming temptation is to cover-up and hope for the best. The "oops," like the lone wolf, is usually not fatal or structural. Yet how the scenario plays out will heavily influence future behavior.

The last type is the "conspiracy." As the term implies, it is the effort by more than one individual to perpetuate a fraud. These latter two situations are the primary focus of this book. These situations are the *company killers*. Conversely, they should be the easiest to prevent to a diligent organization: The bigger the conspiracy, the greater the risk to the conspirators that they involve someone who exposes the conspiracy.

Second, while a qualitative concept, ethics can be measured. Ethical and unethical behavior show up in costs, growth, employee turnover, employee satisfaction, and, of course, return on equity. Attitudes can be surveyed and the results compared over time and across your organization. While there is a temptation to dismiss qualitative results as too soft, there are a number of methodologies and tools that can analyze behavior and produce actionable data.

Finally, since this is not fiction, I don't mind revealing a key plot point early. As you read this, keep in mind the notion of "trust." Trust is so important to an organization at the macro- and microlevel that it is essential to discuss upfront. The reason we focus on personal ethical behavior and the aggregate ethical behavior of an organization is because it is the basis of building trust between individuals and between organizations. At the core, trust is the most essential way to reduce cost and build value.

As mentioned in the preface, throughout the book there are case studies and examinations of ethical lapses that focus on the role of the senior executives. I urge you to examine these situations with an eye toward identifying the breakdown of trust in the relationships. This is important because, while trust is a "touchy feely" concept, as senior executives you often do not have enough raw data to understand the facts well enough. In point of fact, where issues of fraud and malfeasance are involved, real facts are even *harder* to come by as they are often covered up or obfuscated by those perpetuating the unethical behavior.

What you are left with is a gut feeling for the situation: Do you trust the facts? Do you trust the statements? Do you trust the individuals? If not, it is time to act.

CASE STUDY — A CFO'S DILEMMA

Years ago, there was a chief financial officer (CFO) of a manufacturing company about to be taken public. Times were good: The company had successfully come out of the development stage and started to ship product, had negotiated relationships with the top resellers in our industry and, in so doing, secured upward of 85 percent of the distribution chain, and the initial reception from the investment banking community was very good. The company was buzzing with excitement—especially as employees and management started to believe their stock options would be worth a fair amount of money.

The accounting group and outside auditors had recently completed the audit of the second-quarter numbers that would be used as the basis for the offering. Summer was upon them and there was a lull in the activity as the company was in the final stages of deciding on an investment banker. Returning from lunch one day, the CFO saw a tractor-trailer at the loading dock. This was good news because it meant the company was shipping product. Taking a quick detour, the CFO asked the manufacturing manager

(*Continued*)

where the product, a specialized machine, was headed. "Here," he said. "It is coming back for a software upgrade. It will be going back out in the next day or so." Oh, well, the CFO thought, and headed to his office.

But something nagged at him. The company's processes included a fairly detailed forecast of revenue, and the CFO did not recall anyone forecasting upgrade revenue for the foreseeable future. Later in the day, curiosity getting the better of him, the CFO went back down to the manufacturing manager and asked if he knew if the software upgrade had been forecasted and for when—the CFO's assumption being that this machine was being upgraded early. "No, we are not charging for this. It's included in the sales price. But it is no big deal; it costs us nothing. Plug in a computer and press a button; maybe 20 minutes of work," he said.

The CFO had negotiated the contracts when he was an outside advisor to the company, and he was damn certain that there were no "free" software upgrades. The CFO stated, "I am fairly certain upgrades were not included in the price."

"Beats me, but I know this machine is getting an upgrade."

This could be a very big problem. The company recognized the revenue based on acceptance of the device. If there was an expectation of an upgrade, there could not be acceptance. No acceptance, no revenue. Having just completed the audit, the CFO knew the company had booked the revenue for all machines shipped to date.

The CFO pored over his files, but there was nothing in the files to indicate the upgrade was due. The CFO then tried to contact the head of engineering, but he was away on vacation. The nagging feeling would not go away, so the CFO went down to the head of engineering's office and grabbed the chief engineer's customer file. In it was a letter—a one-paragraph letter—agreeing to the upgrades. The CFO made a copy and went back to his office. Sitting there, the CFO must have read the letter dozens of times looking for a way out. More correctly, he was looking for an easy way out. There was no way around it: The letter meant that the

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