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The Anatomy of a Corporate Scandal: Unauthorized Credit Cards, Greasy Cup Holders and a Surefire Recipe for a Corporate Scandal

Compliance and Ethics

CHEAT SHEET

- ***Striking a parallel.*** A 1991 incentive program at Sears, Roebuck & Company spiraled into fraud after employees felt pressured to meet quotas or risk getting fired.
- ***Shocking revelations.*** The 1961 Milgram experiment and the 1951 Asch experiment revealed the extreme pliability of human nature. The experiments showed how minor changes could make test subjects either totally obedient or totally resilient.
- ***Conscious capitalism.*** A conscious capitalist is a leader that harnesses positive social pressure to promote ethical practices. The four tenants of conscious capitalism are higher purpose, stakeholder integration, conscious leadership, and conscious culture.
- ***The road ahead.*** By recruiting, retaining, and motivating the best employees, conscious capitalists avoid compliance trouble and set a foundation for long-term success.

Tragedy strikes a great bank.

For the past several months, Wells Fargo, a 164-year-old institution with the highest market valuation among any bank in America, has been rocked by scandal. According to regulators, since 2011, Wells Fargo employees had secretly created over two million unauthorized bank and credit card accounts for customers without their knowledge. Bank employees involved in this scheme went so far as to create phony PIN numbers and fake email addresses to enroll customers in online banking services. In doing so, employees could move funds from existing accounts into newly created ones without their consent. In addition to paying for services they never requested, customers were charged for insufficient funds or overdraft fees because there wasn’t enough money in their original accounts.

In the aftermath of its discovery by the Consumer Financial Protection Board (CFPB), Wells Fargo has paid a heavy price. Over 5,300 employees were fired — including their CEO after he was roasted alive in congressional hearings. The company has been slapped with the largest penalty in CFPB’s history: US$185 million in fines and US$5 million to refund customers. Sadly, Wells Fargo, a great institution that has contributed much to US growth for nearly two hundred years, has seriously damaged its reputation and added another stain to a banking industry that has struggled to regain public trust since the scandal-driven 2008 financial crisis.

For those of us in the corporate governance and compliance world, the Wells Fargo debacle presents several significant questions that we must answer to help our firms avoid a similar fate. Since the passage of the Dodd Frank Wall Street Reform and Consumer Protection Act in 2010, the banking industry has been subjected to extraordinary regulatory scrutiny and compelled to implement a comprehensive regime of new internal controls. Moreover, the CFPB has been pursuing its mission to protect consumers from abusive banking practices with a crusader’s zeal. In this climate, how is it possible that thousands of employees in one of the country’s most respected banking institutions systematically defrauded millions of customers over a period of years? For corporate counsel, this is not an academic question. If such a massive scandal can happen at Wells Fargo in a tight regulatory environment, it can happen anywhere. The automotive repair industry and important discoveries in social psychology, however, point the way to some answers.

Sears automotive hits a bump in the road

In 1991, Sears Roebuck & Company, one of the most highly respected companies in the United States, had a thriving nationwide automotive repair business that was facing competitive pressures. In response, the company implemented an incentive program for its mechanics, installers, and tire changers. Hourly wages were cut and production quotas were established with financial incentives that motivated employees to increase productivity and profitability. The incentive program pressured workers to sell a specified number of shock absorbers or struts per hour. At one store, employees were told to sell five front-end alignments, eight sets of springs, eight sets of shock absorbers, and two tires each day. Employees who did not meet these goals were punished by cutting their hours, transferring them to another Sears department, or firing them.

Employees reported that managers put enormous pressure on them to perform. One employee told the press: “I’m torn between moral integrity, losing my job, and trying to figure out how to work all this out.” A Sears service advisor reported that he requested a job transfer because he “couldn’t stomach the pressure to sell. It wasn’t right. You sold things to people to meet your quota for that day, but you didn’t feel right about it.”

It wasn’t long after Sear’s new incentive program was implemented that customer complaints started rolling in. In response, undercover agents in California’s Bureau of Automotive Repair (BAR) conducted 38 undercover runs at Sears shops throughout California. In 34 of those runs, the BAR found that mechanics either performed or recommended unnecessary procedures. Overcharges averaged US$223, peaking on occasion at US$550, while some cars left Sear’s shops in worse condition than before they were “repaired;” the BAR claimed that one car was left without brakes. The Sears shops were routinely replacing parts that were in good working order and had less than 20 miles of use.

Following this investigation, the California attorney general initiated legal action against the Sears. Ultimately, dozens of other state attorneys general followed suit. These actions resulted in settlements costing Sears millions of dollars. Its stock price tumbled. Like Wells Fargo, this retail giant was savaged by the press and became the butt of jokes on national television. David Letterman lampooned the company by listing the “Top 10 repair jobs recommended by the Sears Automotive Department.” These included: “Grease the ashtrays” and “Rotate the tires four times clockwise.”

The parallels between the Sears and Wells Fargo scandals are striking. At Wells Fargo, aggressive sales targets were set to boost profits driven by what some employees characterized as a “toxic sales culture.” One employee reported to the press that “the whole foundation of Wells Fargo is cross-sell, cross-sell, cross-sell.” This refers to the bank’s sales approach of offering customers with a checking account many other types of products — including credit cards, home loans, and lines of credit. There is certainly nothing wrong with offering consumers additional products; however, according to the same Wells Fargo employee, the bank pushed it beyond reason. The pressure on employees to sell was disturbingly intense. “We were all miserable, and it was just soul crushing to walk in every day.”

In addition to the aggressive sales goals, employees reported abusive management techniques aimed at those who did not “perform.” One employee told reporters: “It was multiple occasions where I saw my coworkers were cracking under the pressure. Tears, crying; constantly getting pulled into the back room having one-on-ones for coaching sessions.” Another said: “It’s like being called into the principal’s office. Sit down at the large conference table, no windows in this room, they shut the door, lock the door.” Then managers would issue formal warnings which employees were compelled to sign. They were further told: “If you don’t meet your solutions, you’re not a team player. If you’re bringing down the team, then you will be fired and it will be on your permanent record.” One employee stated that after one of these coaching sessions, she threw up in the wastebasket under her desk and compared the job to being in an abusive relationship. Dozens of workers also reported that they were fired for refusing to engage in unethical sales practices and/or reporting the fraud to the company’s hotline.

Like Sears, Wells Fargo managers created a pressure cooker sales environment in which the massive fraud that occurred was completely predictable. This is not because “bad people” gravitate toward the auto repair and banking industries. It’s not because Sears and Wells Fargo hired “bad apples.” Instead, as social psychologists have observed for many decades, social dynamics — obedience to authority and conformity — are a dominant driver of human behavior that can induce good people to do bad things.

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We’d all like to think that if we found ourselves at Wells Fargo or Sears that we would have the strength of character to resist social pressures to engage in wrongdoing. But the reality is that every one of us is just as susceptible to social pressures from peers and superiors as the employees at these institutions. Decades ago, two classic experiments demonstrated the power of social dynamics to override moral sensibilities to the utter shock and amazement of the psychological community.

The Milgram experiment and obedience

In 1961, Stanley Milgram, a Yale University psychologist, conducted a series of experiments aimed at testing the degree to which individuals would obey the instructions of an authority figure even if doing so would cause another person harm. Test subjects were placed in the role of the “teacher,” in what they were told was an experiment to determine if punishment would improve memory. The teacher was instructed to administer electrical shocks to the “learner” every time they provided a wrong answer to a memory test question. The shocks increased in intensity with every wrong answer. The “learner,” who was part of the experiment and who was seated in another room, actually received no shocks. However, they shouted in pain with each jolt and even complained of a heart condition as the shocks increased. When the shocks reached 450 volts, the learner stopped responding altogether.

Milgram described the experiment to a group of 40 psychologists and asked them to predict the percentage of test subjects that would go all the way. The group predicted that only one percent would do so, stating that “only sadists would engage in such sadistic behavior.” These scientists missed the mark by a wide margin. To everyone’s astonishment, 65 percent of test subjects went all the way to 450 volts. The vast majority of people, the “teachers,” shocked their “learner-victim” over and over again despite their increasingly desperate pleas to stop. Most of these individuals protested to the experimenter and expressed their reluctance to continue. But the experimenter always gave them reasons to do so and the test subjects obeyed the experimenter’s commands and continued to administer what they thought were painful shocks to another human being even though they did not want to.

The Milgram experiment also revealed the extreme pliability of human nature. Experimentors could make almost everyone either totally obedient or totally resistant to authoritative pressures depending on the situational variables. Milgram was able to demonstrate that compliance rates could soar to over 90 percent of people continuing the 450-volt maximum, or be reduced to less than 10 percent, by introducing just one crucial variable into the compliance recipe. To get maximum obedience, Milgram made the test subject a member of a “teacher team.” The job of pulling the shock lever to punish the victim was then given to another person, while the test subject assisted with a different part of the procedure. To create conditions in which participants refused to comply, Milgram provided social models of peers who rebelled.

The Asch experiment and conformity

In 1951, Solomon Asch conducted an experiment that also took the psychological community by surprise. In this experiment, a test subject was placed in a room full of confederates who were clandestine participants that were coached by Asch to answer questions in a particular way. Both the test subject and the confederates were seated together in a classroom, and were asked obvious questions about the length of a line printed on cardboard posters. In accordance with the test protocol, the confederates would occasionally collectively provide the wrong answer. To his astonishment, Asch found that 76 percent of the test subjects would go along with the confederates when they provided wrong answers.

The results of the Milgram and Asch experiments are difficult to accept. We would all like to think that we have the courage and strength of character to resist pressures to conform. But, these studies, and the many that have followed since, demonstrate a universal vulnerability to powerful social dynamics. Like it or not, the majority of us will do what our boss tells us to do — especially when our jobs are on the line. The power of social dynamics in the workplace is born out in the Sears and Wells Fargo scandals, as well as countless other corporate meltdowns in which good people were induced to do bad things. As Philip Zimbardo points out in his book *The Lucifer Effect*, the root cause of such tragedies is not a few “bad apples,” but, instead, “bad barrels.”

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Sears and Wells Fargo did not hire thousands of bad apples. Instead, they put good people in bad barrels filled to the brim with a toxic stew, comprising of the following sure-fire recipe for a massive corporate scandal:

- Add one-part unrealistic sales targets to two-parts management pressure to perform, and three-parts threats and retaliation against those who refuse to obey; and,
- Mix in an organization led by people focused on maximizing profits rather than acting in their customers’ and employees’ best interests.

Sadly, the ubiquity of this poisonous brew, and its predictable consequences, is apparent in headlines that report an unending chain of breathtaking corporate scandals that are not limited to the banking and automotive repair industry. This toxic formula has ruined thousands of promising careers and shattered the reputations of every corporation that has tasted it. Fortunately, there are definitive steps that we as corporate counsel can take to chart a different course.

Using social dynamics for good by being a “conscious capitalist”

First, it’s important to recognize that social dynamics drive behavior in every organization. Savvy leaders harness the power of social dynamics to build and sustain ethical cultures; ones in which there is social pressure to follow the rules and do right by all stakeholders. There are many paradigms that we might rely on to help our clients adopt such a strategy to both avoid disaster. However, in my view, the best model for achieving this end are the four tenets of conscious capitalism set forth by John Mackey and Raj Sisodia in their book entitled *Conscious Capitalism*: higher purpose, stakeholder integration, conscious leadership, and conscious culture and management.

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Higher purpose

Conscious businesses have a higher purpose. This means they have taken the time to find answers to basic questions like “Why do we exist?” and “What is the contribution we want to make?” They understand that by pursuing a higher purpose with passion, they will create the “magnet” that holds the organization together, ultimately attracting the right team members, customers, suppliers, and investors, under a common cause. They also understand that when leaders put a higher purpose in front of profit, not only do they avoid the kinds of ethical pitfalls experienced by Wells Fargo and Sears, but they also set a tone that is essential for success.

Stakeholder integration

Instead of looking for tradeoffs between stakeholders, conscious businesses look for synergies. They consciously look for ways to make all key stakeholders better off by aligning their interests in the same direction. This paradigm shift, from looking at business as a “zero-sum” game to a “positive-sum” game, recognizes that at its core, business is a highly collaborative activity. By consciously seeking ways to run a business in a manner that benefits employees, suppliers, customers, shareholders, the environment, and the communities in which they all operate, companies can maximize the energy, creativity, loyalty, and engagement of those that are the life blood of every for-profit enterprise.

Conscious leadership

Mackey and Sisodia describe conscious leaders as “strong individuals who possess exceptional moral courage and are able to withstand constant scrutiny and criticism from those who view business in a more traditional, narrow manner. Above all, conscious leaders view themselves as trustees of the business, seeking to nurture and safeguard it for future generations, not to exploit it for the short-term gains of themselves or current stakeholders.” This is a pretty high bar, and may strike some as a mythical corporate superhero rather than a flesh-and-blood person. However, I think it’s self-evident that business professionals can optimize their effectiveness by aspiring to become “conscious leaders.” Had such leaders been at the helm at Wells Fargo and Sears, it’s certain that they would have avoided the scandals and enhanced rather than diminished their firms’ reputations.

Conscious culture

According to Mackey and Sisodia, a conscious culture has seven important attributes: trust, accountability, caring, transparency, integrity, loyalty, and egalitarianism. Although a more expansive discussion of these attributes is beyond the scope of this article, I suspect that most people would agree that companies with these qualities likely have significant advantages over companies that lack them. As Peter Drucker once said: “Culture eats strategy for breakfast.” Leaders must focus getting their culture right in order to effectively implement any strategy.

Good guys finish first

Before you dismiss the tenets of conscious capitalism as an unrealistic, quixotic business model that’s unsuited to the dog-eat-dog world that we live in, you should know the data shows the opposite is true. Practicing conscious capitalism not only reduces compliance risks, but it also maximizes long-term profitability. Mackey’s and Sisodia’s research shows that over both the short and long term, companies that practice conscious capitalism outperformed the market by a significant margin. By recruiting, retaining, and motivating the best and earning stakeholder trust, conscious capitalists avoid trouble and set a firm foundation for long-term prosperity.

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Despite the clear lessons from the past, and the strength of the conscious capitalism paradigm, those of us intent on bringing these ideas to our companies have our work cut out for us. The profit-driven sales model is so well entrenched in most companies that getting our colleagues to put faith in another model will not be an easy task. Wells Fargo appears to have learned this lesson the hard way. They have eliminated sales targets and are airing commercials touting their commitment to serving their customers’ needs. The trick is to get our clients to take similar steps before scandal arrives at our doorsteps.

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