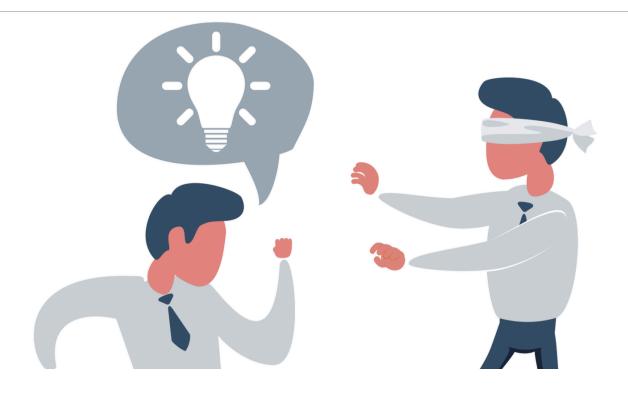


Business Ethics: Have the Courage to Recognize and Respond to Red Flags

Compliance and Ethics



While visiting a friend's house to watch a movie one rainy evening, she mentioned to me she wasn't sure if the sump pump in her basement was working properly. She said she moved the plunger up, but the pump did not turn on as expected.

Instead of immediately putting our shoes on and trudging down to the basement, we both elected to finish watching the movie. When we did get around to checking on it, the basement was covered in two inches of water.

It wasn't long before I discovered the apparent root cause of the failure. The sump pump was plugged into an extension cord that was, in turn, plugged into a wall socket just above a shelving unit her cat used as a launching pad. One of these leaps must have partially dislodged the plug from the socket.

When I plugged the extension cord in, the pump started up immediately. Once the pump drained most of the water, hours of work followed to rescue soggy boxes and their contents, squeegee water out of carpets, and push the puddles on the floor toward the sump.

The next day, just before my friend and I departed for a Halloween party, I checked on the pump and noted it was running, but no water was being discharged. I removed the pump from the discharge pipe and turned it on briefly to see if the pump was defective. A jet of water from the pump outfall confirmed that was not the issue. After re-attaching the pump to the discharge tube, it began working again to drain water from the sump and off to the party we went.

The problem

After returning from the party, we checked to make sure all was well only to discover a flooded basement and a pump that was running but not discharging the water. Maddening! This time, after

disconnecting the pump from the discharge tube, I removed the check valve to see if it was functioning properly. Upon inspection, I saw that a metal disk had broken loose from the rubber valve and was likely blocking the flow of water out of the discharge pipe.

Off to Home Depot we went to purchase a new check valve. Once installed, all was working well again. The water receded and we spent hours swamping out the basement for a second time. Late in the evening the next day, my friend called me at home just as I was preparing for bed. She explained that the pump had stopped working altogether.

The motor was burned out and water was rapidly rising in the sump. By this time, we had both learned our lesson and we took decisive action to avoid a third flood. I instructed her to start bailing as I rushed over to her place with a submersible pump that we hooked up to keep the water at bay until the next morning.

Early the next morning, we were off to Home Depot again, this time to purchase a new pump and PVC tubing to connect the pump to the outfall tube. Hours later, we had everything reassembled and functioning properly. Happily, the basement has been dry ever since.

The solution

Reflecting on this nightmare, I noted similarities in our failure to respond to the sump pump issues to lapses in corporate governance that frequently culminate in costly government enforcement actions. Deepwater Horizon's catastrophic explosion and oil spill, Wells Fargo's consumer fraud scandal, and Toyota's disastrous reluctance to take consumer complaints about stuck accelerators seriously come to mind.

Like many directors and corporate executives who ignore red flags until it's too late, my friend and I should have checked on the pump at the first indication there was a problem. The first two times we discovered the pump was not working properly we should have taken the time to sort out the root cause and fixed the problem.

Had we done so, we could have avoided both floods. Instead, like many corporate leaders faced with danger signs, we took the "cross your fingers and hope for the best" approach. But later we paid the price for our poor judgment.

Like corporate leaders, my friend and I failed to respond appropriately to red flags regarding the pump's performance because such vigilance and responsiveness is not cost-free. My friend and me would have had to delay watching a movie and shlep down into a basement to diagnose the initial pump failure and we might have been late for the Halloween party had we taken the time to discover and replace the faulty check valve.

Likewise, corporate vigilance and responsiveness to red flags can be, and often is, costly.

Company leaders who confront red flags directly may be compelled to shut down production facilities for extended periods of time to remedy safety issues, initiate costly product recalls, or halt highly profitable but flawed marketing programs, report transgressions to regulators, and offer compensation to customers defrauded by such programs. It is difficult for even the most conscientious business leaders to confront such harsh realities and execute necessary corrective actions.

I'm not the first to make this observation. In 2020, the HEC Paris Business School and University of College Dublin published a study based on data gathered from interviews with financial advisers, bankers, and regulators in the wake of the Irish banking crisis. The researchers found rather than being oblivious to the clues of an imminent crisis, managers often overlooked them as something else or optimistically under played the magnitude of the potential consequences.

In another study published in a 2011 *Harvard Business Review* article entitled *How to Avoid Catastrophe*, the authors report "[t]he problem is that near misses are often overlooked – or, perversely, viewed as a sign that systems are resilient and working well. That's because managers are blinded by cognitive biases."

In other words, like my friend and me, they find it difficult to come to grips with and confront the consequences of the flashing red warning signals that appear so blaringly obvious in hindsight.

The lesson

It took my friend and me two flooded basements to learn our lesson and respond decisively to avoid a third flood. I'd like to think the next time I encounter warning signs of impending disaster at home or at work, I'll have the wisdom and courage to mount a swift and effective response. My hope is you and your colleagues will do the same.

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