

The Dilemma of the Successful CEO

The cover of *Fortune* recently featured 21 men and women whom the magazine hailed as “business superstars.” They were asked to relate the best advice they ever got. One good piece of advice that they *should* have gotten, given recent events, is “Don’t let yourself become a business superstar. If you do, there could well be trouble ahead.” The ancient Greeks spelled out the problem in such tragic dramas as *Oedipus Rex* and *Antigone*: *hubris* (pride) leads to *ate* (an act of arrogance offensive to the gods), which results in *nemesis* (infamy and death). A more contemporary formula is, of course, “Pride goes before the fall.” The admonition should have been made to the swelling ranks of once-powerful business executives now facing trials or prison sentences for fraud. But it applies to all successful CEOs and to successful businesspeople in general.

To explore the problem of arrogance and fraud, I examined the 25 largest cases worldwide involving allegations of corporate fraud that surfaced since accounting irregularities at Sunbeam became public in 1998. I studied each company’s incentive system for top management, the CEO’s reputation, growth targets, analysts’ expectations, and rules for corporate governance. I looked for evidence of overvaluation and examined price movements around the time that problems with each company’s books were discovered. All the cases—including such well-known examples as Enron, WorldCom, Adelphia Communications, Ahold, and Parmalat—involved publicly traded companies whose top management was directly or indirectly implicated in the accounting troubles. The companies (21 of which were American, interestingly) made the top-25 list on the basis of the absolute amount of fraud alleged, the amount of

fraud relative to company size, and the company’s size itself. Together, they accounted for \$25 billion of corporate malfeasance.

Surprisingly, the story that emerges from the research is not about bad corporate governance per se, since the 25 companies scored the same on corporate governance issues, on average, as the set of companies I used as a control group. The story turns out, instead, to be about the dilemma of the successful CEO.

What Went Wrong?

Companies and, in particular, their shareholders look desperately for successful leaders. The danger starts as soon as one is found. The new CEO gets increasingly wealthy because of huge stock options and bonuses. In 2000 the CEOs of the companies that would later be accused of fraud had eight times higher stock pay (the sum of exercisable and nonexercisable stock options, plus stock holdings, at year-end) than their peers in the control group: \$1.2 billion, on average, compared with \$150 million.

Along with big checks come big reputations. Indeed, some CEOs acquire icon status and celebrity chic. The heads of the companies in which fraud was alleged were cited, on average, three and a half times more often in the business and popular press than their counterparts in the control group. Some, like Kenneth Lay of Enron and Bernard Ebbers of WorldCom, were quoted over ten times more often.

Before long, tens and sometimes hundreds of millions of dollars of incentive pay as well as oversized reputations are at stake. And some of the most successful CEOs are at great risk of losing it all because they have committed themselves to unrealistic targets.

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Precisely because they are so successful, these CEOs set increasingly high goals. They do so for two reasons. First, to remain successful in the stock market and protect their immense stock holdings, they must increase profits by 12 to 20 percent a year, since those are the targets needed to outperform the market. Second, they start to believe in their own hype. Ebbers, now facing up to 85 years in prison for his role in the WorldCom fraud case, developed “a little bit of a God syndrome,” said one vice president at the company.

The superstars become untouchable as they become more and more powerful. Having committed themselves to unrealistic annual growth targets (on average 18 percent, or the equivalent of 230 percent growth every five years, in the 25 companies in my study—compared with 7 percent annual growth, or 40 percent growth every five years, in the control group), they sometimes feel as though they have no choice but to start fiddling with the numbers and cooking the books. But eventually they fall, and when they do, investors lose their money, employees lose their pensions, and the public loses trust in the corporate world.

Many studies (including those conducted by Manfred Kets de Vries, a psychiatrist and management professor at the INSEAD business school) have shown that narcissism is an occupational hazard for successful leaders, especially in the case of charismatic CEOs. Narcissism is at the same time an addictive drug and an important ingredient for success. Narcissism leads to hubris. Successful narcissistic leaders are tempted to surround themselves with mirrors, in the form of yes men. Such leaders lose touch with reality and tolerate no contradiction. The success of the CEO is the very proof that he or she is always right. Hubris strikes, and Icarus, who has tried to fly to the sun, falls into the sea.

The mechanisms that create success and the mechanisms that are, in turn, created by success (staggering compensation, iconic reputation, unrealistic targets) also stimulate hubris and can cause catastrophe. Ambition and self-confidence—two characteristics necessary to becoming a successful leader and to climbing to the very top—are also inherently dangerous. Ambition can be very close to hubris, and there is a thin line separating self-confidence from narcissism.

The fall from grace comes suddenly, but not as suddenly as it may appear. On the day the allegations of fraud became public in the 25 companies I studied, 26 percent of the value, on average, vanished into thin air: \$73 billion was lost. But savvy investors had anticipated these negative effects well in advance: in the year before the news of each scandal, 40 percent of the market value of the 25 companies, relative to the market index, had vanished. Tens of thousands of investors had read the signs.

What Can Be Done?

What can companies do to prevent irresponsible, value-destroying decisions and fraud—or at least to lessen the chances of their occurrence? Systemic changes are needed in the following areas:

- *Incentive Compensation.* Stop paying excessive sums; base CEOs’ options and bonuses on their performance relative to their counterparts.
- *Target Setting.* Adopt sustainable strategies and set realistic targets; if necessary, just say no to Wall Street.
- *Image Control.* Prevent CEOs from becoming “sun kings”; just say no to journalists.
- *Market Watching.* Carefully follow and read the stock market and your (relative) stock price to watch for early signs of trouble.

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- *Real Corporate Governance.* Recognize that governance is essentially about the control of power; understand that there are limits and dangers to the CEO model and that it is vital to have an independent and strong chair and CFO.
- *Corporate Culture.* Recognize also that good governance is not about rules and regulations; instead, it is about instilling and nurturing a healthy and ethical corporate culture.

Corporate fraud and the misguided leadership of narcissistic sun kings are much more widespread problems than is often assumed. And their cost is much higher, too. From 1978 through 2002, according to a study of the U.S. market by Jonathan M. Karpoff of the University of Washington and two other researchers, federal regulators initiated 585 enforcement actions for financial misrepresentation by publicly traded companies, naming 2,310 individuals and 657 companies as potentially liable parties. The legal penalties imposed were substantial. For example, individuals were assessed \$15.9 billion in fines and civil penalties, and 190 managers received jail sentences for financial-reporting violations. Companies were assessed an additional \$8.4 billion in fines and damages through class-action lawsuits. Beyond the cost in dollars, the damage to reputations is severe: the Karpoff study puts it at 12 times the amount of penalties imposed through legal and regulatory processes. This evidence belies a widespread view that financial misrepresentation is only lightly disciplined.

But punishment is not a remedy, and good governance—at least as it is measured in corporate governance codes, codes of conduct, and legislation like Sarbanes-Oxley—is not a solution. Corporate culture is. “In the end, corporate governance is indeed about corporate culture,”

Gerard Kleisterlee, the CEO of Royal Philips Electronics, said in my discussion with him about the problems caused by the sun kings. “Once a sun king has made it to the top, nobody or nothing—not even corporate culture—can stop him anymore. It’s too late. But what corporate culture should and can do is to keep narcissistic leaders from climbing through the ranks and becoming CEOs in the first place.”

Most of us read these stories of fraud and arrogance and think that we would never succumb to the pressures and temptations. But recognize how strong these pressures and temptations are and how little others will do to help you resist them.

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Cover: “Icarus” from the illustrated book *Jazz*, by Henri Matisse, 1947.
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