

The Dark Side of Leadership: Catastrophic Failure

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Abstract

Recent history provides us with numerous examples of leadership and organizational failures caused by Black Swans or Predictable Surprises. With enhanced awareness and organizational capacity, leaders will be positioned to grow and sustain their organizations in the presence of catastrophic risk. Today's leaders are responsible not only for providing a vision of the future and the plans to achieve it, but for protecting their organizations and their followers from catastrophic failures. The recognition and fulfillment of this responsibility is of critical importance to the long-term success and viability of global leaders and their organizations. This article discusses catastrophic failure and its impact on organizations. It builds on Nicholas Taleb's concept of the Black Swan, Max Bazerman and Michael Watkins' concept of Predictable Surprises and Jim Collins' Stage Three Marker of Failure – Denial of Risk and Peril. The article concludes with proposed solutions to help prevent these catastrophic failures in the future.

At times leaders fail. It is inevitable. Some fail morally, damaging their reputations and depriving their organizations of their expertise and leadership. Former President Bill Clinton, former New York Governor Elliot Spitzer, and former Hewlett Packard CEO Mark Hurd are all examples of this type of failure. Others fail operationally, unable to lead their organizations to the level of performance required by stakeholders. Former Apple CEO John Sculley and former Home Depot CEO Bob Nardelli are both examples of this failure. Yet still others fail to protect their stakeholders from catastrophic disaster. These leaders fail to anticipate future unknown events or prepare for potential catastrophes that can be anticipated. Such catastrophic failures can result in the loss of billions of dollars of investment capital, thousands of jobs, and even the loss of life. The failures of Ken Lay, former CEO of Enron, Rick Wagoner, former CEO of General Motors, and Dick Fuld, former Lehman Brothers CEO all fall into this category. Failures of this nature not only impact the leader's organization and stakeholders, but can affect whole industries and economies on a global basis. Therefore, today's leaders are responsible not only for providing a vision of the future and the plans to achieve it, but for protecting their organizations and their followers from catastrophic failures. The recognition and fulfillment of this responsibility is of critical importance to the long-term success and viability of global leaders and their organizations.

Failure to Recognize Catastrophic Risks

All organizations face risk: market risk, operating risk, financial risk and strategic risk. To address and manage these risks most organizations have a risk management function. However, this risk management function typically addresses the “known” operational, financial and strategic risks through various techniques such as insurance, in-house risk-reduction programs, risk transference, and risk hedging. In addition, various tools and techniques are used to identify these known risks, assess their potential financial impact, and assess the potential probability of the risk event occurring. This function is usually delegated to subordinate leaders within finance or human resources. However, while significant effort is expended to mitigate these “known” risks, little effort is expended with respect to “unknown” risks, including strategic and catastrophic risks.

Acknowledging Potential Unknown Risks

Statistical researchers Spyros Makridakis, Robin Hogarth and Anil Gaba, in their article, *Forecasting and Uncertainty in the Economic and Business World*, address the issue of business forecasting and planning and the need for a framework that allows leaders to face the future with greater insight. They make several observations that support the hypothesis that “accurate forecasting in the economic and business world is usually not possible.”¹ Most importantly, they observe that practically all business and economic endeavors are subject to significant uncertainty, since they are subject to events that are not able to be predicted.² Makridakis et al. have identified two types of uncertainty faced by leaders in the business/economic world: “known” and “unknown” uncertainties. Known uncertainty is that where there is continuity between past and future events that can be modeled and the related risk quantified for a wide range of business and economic applications. Commodity prices, the time to complete a task, or the timeliness of a subway train are all examples of known uncertainties. This is the type of risk addressed by most risk management functions.³

The second type of uncertainty, the unknown uncertainty, is that which may be identified in advance but is rare and unexpected, with critical consequence, and unable to be predicted with reasonable probability.⁴ Little effort is expended in attempting to manage this type of risk principally because the magnitude of the risk and its probability are considered difficult or impossible to measure, or even to conceive.

The Black Swan

A subset of the unknown uncertainty is the strategic or catastrophic risk known as the “Black Swan.”⁵ The notion of the Black Swan was introduced by author and financial analyst Nicholas Taleb in his best-selling book, *The Black Swan: The Impact of the Highly Improbable*. Taleb suggests that we do not live in a probabilistic world, i.e., a world in which we can estimate with a high probability (99.5%) that events will fall within three standard deviation of the normal distribution, as we are taught and trained to believe.⁶ In fact, he suggests that we do not even live in a six-sigma world, accounting for virtually all potential events.⁷ However, it is with these prevailing perspectives that existing risk management functions operate. Global leaders must recognize that they lead in a world subject to outliers, the potential of which cannot be ignored.

Taleb further argues that the Black Swan is the most dangerous of all risks.⁸ He describes a Black Swan as an event with the following three attributes: 1) it is a statistical outlier, as it lies outside the realm of regular expectation for the organization, because nothing in the past can convincingly point to its possibility; 2) it carries an extreme organizational or financial impact; 3) in spite of its outlier status,

human nature makes us concoct explanations for its occurrence after the fact, making it explainable and predictable.⁹ Taleb identifies the October 1987 stock market crash and the September 11, 2001 terrorist attacks as Black Swans.¹⁰ The financial crisis of 2008 and rapid bankruptcies of Enron and General Motors may also be categorized as Black Swan events. This type of risk is that which destroys companies, resources and even lives. Leaders must make every effort to identify potential Black Swans, and to avoid their devastating impact.

Predictable Surprises

Authors Max H. Bazerman and Michael D. Watkins also address the issue of catastrophic leadership failure in their book, *Predictable Surprises: The Disasters You Should Have Seen Coming, and How to Prevent Them*. Whereas Taleb addresses the improbable risk event, Bazerman and Watkins focus on risk events that occur when prior information was available to allow for the avoidance of the event, or the minimization of its impact.¹¹ Bazerman and Watkins define a predictable surprise as a problem that was:

1. Known to leadership, but assessed as unsolvable;
2. Getting worse over time;
3. Going to incur significant cost to fix in the present, while the benefits would be delayed into the future;
4. Going to incur a certain known cost in the present while the benefit is avoiding a future cost that is uncertain but likely to be much larger;
5. Not resolved because of the natural human tendency to maintain the status quo.¹²

The authors identify 9/11, the joint failures of Hurricane Katrina (failure to improve the levy system and the post-event mismanagement of the disaster recovery), and the nearly simultaneous collapse of Arthur Andersen and Enron, as examples of Predictable Surprises.¹³ Predictable Surprises may exhibit characteristics of both known and unknown risks.

Black Swans or Predictable Surprises – Does it Really Matter?

The labels that are used to categorize catastrophic failures are largely irrelevant. What does matter is the failure of leadership to predict these events if unknown, and the failure to act on available information if the potential of these events was known. Also relevant is the necessary awareness of these kinds of risk events so that leaders can be vigilant in protecting their organizations and followers from their catastrophic consequences. In addition, leaders must also be cognizant of the reasons why these events occur and why responses to them can be ineffective.

Why Leaders Fail Catastrophically

Bazerman and Watkins provide three probable reasons as to why leaders and their organizations are vulnerable to Predictable Surprises and, by association, Black Swans. They argue that these failures are influenced by psychological, organizational, and political vulnerabilities.¹⁴ Makridakis et al. add that the failure to recognize that leadership takes place in an uncertain world exacerbates the potential for catastrophic failure.¹⁵

Psychological Vulnerabilities

Bazerman and Watkins observe that recent research “has shown that human judgment and decision-making deviates from rationality.”¹⁶ They further believe that “people rely on simplifying strategies, or

cognitive heuristics, that lead them to make predictable errors.”¹⁷ They have identified “five cognitive biases” that are most responsible for Predictable Surprises. These biases are tendencies to:

1. Have positive illusions that lead one to conclude that a problem doesn’t exist or is not severe enough to merit action;
2. Interpret events in an egocentric manner. That is, when considering the fairness of proposed solutions to a looming crisis, individuals tend to allocate credit and blame in ways that are self-serving;
3. Overly discount the future, reducing the courage to act now to prevent a disaster that is believed to be quite distant;
4. Maintain the status quo, and refuse to accept any harm that would bring about a greater good;
5. Delay or avoid investing in preventing a problem that has not been personally experienced or witnessed through vivid data.¹⁸

Bazerman and Watkins argue that these cognitive biases or errors work together and in conjunction with organizational and political vulnerabilities.¹⁹ Leaders must be cognizant of the psychological biases that reside within them in order to minimize the risk of future failures. In addition, understanding the limits of human cognition also allows leaders to create the type of organizational and decision structures that can help minimize errors in leadership judgment.²⁰

Organizational Vulnerabilities

Bazerman and Watkins further argue that in order for an organization “to avoid surprises it must efficiently and effectively engage in four critical information-processing tasks”:

1. Scanning of the environment and collecting sufficient information regarding all significant threats;
2. Integrating and analyzing information from multiple sources within the organization to produce insights that can be acted upon;
3. Responding in a timely manner and observing the results;
4. In the aftermath, reflecting on what happened and incorporate lessons-learned into the institutional memory of the organization, in order to avoid repetition of past mistakes.²¹

When these critical tasks are not sufficiently accomplished the organization becomes increasingly vulnerable to catastrophic failure. Bazerman and Watkins further argue that an organization is particularly vulnerable when it experiences the following types of failures:

1. Scanning failures – of either the external or internal environment due to lack of resources or organizational inattention;
2. Integration failures – inability to consolidate information from different parts of the organization, or to synthesize information into actionable insights;
3. Incentive failures – failure of key personnel to act on available insights due to lack of incentive to do so, or disincentive;
4. Learning failures – failure to distill key lessons from past experience and disseminate throughout the organization, or failure to preserve past lessons.²²

The authors point out that these organizational failures “often compound and reinforce each other.”²³ These failures can be viewed as organizational design failures, and as such, failures of leadership.

Political Vulnerability

Bazerman and Watkins add a third culprit to the cause of Predictable Surprises: the impact of special interest groups.²⁴ They define special interest groups as those “that seek gains for their members with little or no concern for the overall effect of their goals on society, even when the gains to their group are much smaller than the total social cost.”²⁵ The influence of special interest groups, such as trade associations, professional organizations and other large lobbies can be readily seen in public organizations and governments. However, special interest groups can also develop within private organizations. A classic example of internal special interest groups is the evolution of functional silos within an organization that compete for influence, resources, and incentives.²⁶ In addition, high priority initiatives or projects can also fall into this category. When political vulnerabilities such as these are present, leaders and organizations are at risk for Predictable Surprises and Black Swans.

Denial of Risk and Peril

In addition to Bazerman and Watkins, author Jim Collins offers further insight into catastrophic failure in his recent book, *How the Mighty Fall and Why Some Companies Never Give In*. Collins identifies five stages of decline that companies experience on the road to irrelevance or total failure.²⁷ Although all five stages highlight leadership failures, Stage 3, “Denial of Risk and Peril,” specifically addresses the psychological vulnerabilities identified by Bazerman and Watkins and the risk concerns of Taleb and Makridakis. Collins outlines five characteristics, or markers, of being in Stage 3. The first three markers are: 1) amplifying the positive, discounting the negative; 2) making big bets and setting bold goals without empirical validation; and 3) incurring huge downside risks based on ambiguous data.²⁸ These three markers offer potential clues as to why leadership teams fail to identify significant negative environmental factors, and are emblematic of a complete and deliberate disregard for catastrophic risk.

The last three markers of Collins’ Stage 3 are: 4) erosion of healthy team dynamics; 5) externalizing blame; and 6) obsessive reorganization.²⁹ Of particular interest is the erosion of healthy team dynamics. Collins observes that in this stage there is a marked decline in the quality and quantity of dialogue and debate, with a shift toward either consensus or dictatorial management, rather than legitimate professional debate and subsequent unified commitment.³⁰ If dictatorial leadership results, the ability to absorb negative information, assess risk, and appropriately adapt is limited to the whims of one individual. Unfortunately the alternative path is equally dangerous, for as Margaret Thatcher eloquently warned, “Consensus is the death of leadership.” Thus, in addition to the vulnerabilities identified by Bazerman and Watkins, leaders must also be cognizant of Stage 3 conditions developing within their respective organizations, as they may portend the threat of catastrophic failure.

Enhancing Catastrophic Risk Recognition

The avoidance of Black Swans and Predictable Surprises requires leaders to be aware of the psychological biases within themselves, their leadership teams and their followers. In addition, leaders must recognize the vulnerabilities of their organizations, the markers of denial and the resulting potential for catastrophic events. Finally, leaders must continuously acknowledge that they lead in a “hyper-turbulent” world, where uncertainty is a constant companion. If ignored, these three factors combine to severely undermine the recognition of catastrophic potential.

Overcoming the Recognition Problem

Bazerman and Watkins put the recognition problem into perspective in quoting physicist Niels Bohr: “prediction is difficult, especially about the future.”³¹ This difficulty is amplified by the presence of psychological biases and organizational design failures, as discussed above. Leaders can minimize these weaknesses and improve their chances of avoiding Black Swans and Predictable Surprises by first recognizing these symptoms in themselves and their organizations. Furthermore, leaders must recognize that these weaknesses and vulnerabilities are intertwined, and minimizing them requires a comprehensive, organization-wide effort.

Four techniques are recommended by Bazerman and Watkins for establishing and institutionalizing an effective early-warning system in organizations:

1. Redesign the organization’s measurement system;
2. Build intelligence networks;
3. Implement scenario planning; and
4. Initiate a disciplined learning process.³²

The first recommendation addresses the issue of the influence of measurement systems on human behavior.³³ An old adage suggests that “what gets measured gets managed.” However, measurement systems can cause individuals to focus too-narrowly on what is being measured, especially when incentives are involved.³⁴ A corollary is that potential issues may be ignored if not measured in some way.³⁵ Therefore, the regular and periodic measurement of known potential risks must be included in a measurement system so that awareness can be heightened to the point of action.³⁶ Balanced scorecards which incorporate measurements of known risks are an example of measurement systems that can enhance an organization’s ability to recognize and respond to emerging risks.³⁷

Building intelligence networks allows leaders to enhance the critical information gathering process in light of the barriers to information sharing innate in their organizational structures. Bazerman and Watkins recommend the creation of one or more cross-functional teams to focus on information gathering, synthesis and interpretation in areas susceptible to potential catastrophic risks.³⁸ In addition, they recommend that leaders build personal intelligence gathering and analysis networks both inside and outside their organizations.³⁹ This can provide leaders with comparative information to challenge data that is typically gathered and analyzed.

Scenario planning is a technique used to envision and analyze future alternative events or strategies. The goal is to help identify opportunities and threats and assess a risk probability to their potential occurrence. The critical aspect of this exercise, however, is probing for unanticipated risks.⁴⁰ Bazerman and Watkins point out that the key question, “what predictable surprises are currently brewing in our organization?” is rarely asked.⁴¹ They also note that by actively encouraging people to speak up, leaders can bring issues to the surface that would otherwise go unnoticed.⁴² Furthermore, leaders should encourage the exploration of unlikely scenarios that would have profound impact on the organization should they occur.⁴³ This type of scenario analysis can identify potential Black Swans.

While planning for future scenarios is a critical exercise, many organizations suffer from the inability to learn from prior organizational experience and surprises.⁴⁴ As Bazerman and Watkins suggest, “not all emerging threats are novel,” and many similar threats may have been experienced by the organization before.⁴⁵ However, each surprise encountered by a leader and his organization is an opportunity to learn. The authors believe that an organization’s ability to anticipate potentially devastating events can be significantly enhanced “by institutionalizing organizational learning and memory preservation”.⁴⁶ At a

minimum, to help avoid catastrophic events the organization's "most crucial knowledge must be identified and preserved to the greatest extent possible".⁴⁷

Bazerman and Watkins' recommendations specifically address the issue of Predictable Surprises, devastating events for which information was reasonably available. However, these recommendations may be insufficient in identifying potential Black Swans.

Hunting the Black Swan

Makridakis et al. address the issue of Black Swan identification. They outline three steps for enhancing the assessment process needed to identify a catastrophic risk that is yet unknown. The first step is for leaders to accept that they are dealing with an uncertain world; ignoring this fact is not an option.⁴⁸ The key to this step is to find ways of envisioning the full range of possible outcomes: all the things that could go right or wrong.⁴⁹ This can be considered an extreme version of scenario analysis as suggested by Bazerman and Watkins above. The second step is to assess the level of uncertainty as accurately as possible using any and all relevant data.⁵⁰ Critical in this step is to avoid the fallacy that the organization's particular situation is unique, and that no valid information exists on which to form an assessment.⁵¹ The third step is to augment the assessment that was made in the second step.⁵² Since people tend to underestimate uncertainty, as noted in the previous discussion of psychological vulnerabilities, one must use all available information to improve the original assessment, and at a minimum double it!⁵³ The main point is that the assessment of uncertainty has to be broad enough to allow for that which has not been previously imagined. The ultimate key to enhancing the organization's ability to identify potential Black Swans is to generate creative and extreme risk scenarios, and hence, develop strategies that may neutralize the arrival of catastrophic events.

The Acid Test

In light of the above recommendations, leaders and their organizations will still be challenged with two overriding questions: 1) how can an unknown catastrophic risk event be identified; and 2) how can the probability of such an unknown event be estimated? A simple yet effective approach is to start by defining the potential risk event as being totally catastrophic, e.g., total loss of all assets, total collapse of the business model, and total failure of the organization's vision. With this definition in mind, leaders can conduct the following exercise with a leadership team, or groups of followers:

1. Brainstorm all events or conditions that would result in total loss regardless of how improbable;
2. Generate at least ten ideas per team (the most creative, or least apparent, ideas will likely be in the last five of the list);
3. Prioritize the list from most probable to least probable (note that detailed assessment of probability is not important here since the ultimate result of the risk event is total loss);
4. Assign a high-ranking leader to monitor and manage each potential Black Swan;
5. Establish the appropriate quantitative or qualitative indicator for each event;
6. Monitor the established indicators and report to the organization's leader at least quarterly or as part of a regular and periodic operational performance review.

This simple exercise will provide leaders with added insight into their organization's potential to encounter a Black Swan or Predictable Surprise.

One Final Step: Effective Organizational Design

Leaders are ultimately responsible for the well-being of their organizations. However, they cannot do it alone. Their ability to protect the human and financial resources of their organizations from the catastrophic effects of Black Swans and Predictable Surprises will be dependent upon the leaders' ability to engage the entire organization to accomplish this critical task. Catastrophic failures are usually exacerbated by organizational design failures, and thus are another indication of the failure of leadership.

To ensure effective organizational design, Jay Galbraith's "Star Model" provides an appropriate framework for implementing the various recommendations made above. The principle facets of the Star Model are:

1. Strategy (the direction of the organization);
2. Structure (the distribution of authority);
3. Processes (the flow of information or decision-making activities);
4. Rewards (the basis of motivation); and
5. People (the required skills, knowledge and mindsets).⁵⁴

All organizations possess these five basic facets of organizational design, whether intentionally or by accident. With proper alignment, an organization can be designed to facilitate variety, change, speed and integration – the sources of competitive advantage in both today and tomorrow's environments.⁵⁵ Furthermore, in tandem with Bazerman and Watkins' observations on the contribution of organizational failures to catastrophic potential, it is apparent that proper organizational design and alignment is a significant factor in avoiding such failures. Using Galbraith's "Star Model" as a framework for organizational design, a leader can minimize the probability of catastrophic loss by:

1. Accepting the reality of the risks inherent in a "hyper-turbulent" world and embracing a protective, stewardship-based mindset in the "strategy" facet of the design;
2. Delegating concurrent responsibility for this protective mindset to appropriate senior level leaders, and eventually cascading that responsibility in the "structure" facet;
3. Integrating the various risk measurement and recognition processes, including a well-defined organizational learning process, throughout the organization, in the "processes" facet;
4. Ensure that incentives are properly aligned at all levels of the organization to enhance early-warning information of possible high-risk, catastrophic events, to minimize the probability of overlooking valuable information, and to eliminate incentives that may actually increase the probability of catastrophe, as a function of the "incentives" facet;
5. Assign qualified, senior-level personnel, reporting directly to the leader, to the role of strategic risk officer(s) to ensure that this critical function is given the highest strategic priority, as part of the "people" facet.

Proper organizational design can provide leaders with the appropriate alignment of human and financial resources to avoid, or at least minimize, the impact of a catastrophic event.

Avoiding Catastrophic Failure

Recent history provides us with numerous examples of leadership and organizational failures caused by Black Swans or Predictable Surprises. However, these failures and their often devastating consequences can be minimized or even avoided, by the awareness of their potential and by taking timely and appropriate action. To enhance awareness, leaders must understand the nature of the environment in which they lead, and the psychological and organizational vulnerabilities that threaten their ability to appropriately recognize and react to potential threats. Further, leaders must design, align and manage organizations that can function effectively in an environment of “hyper-turbulence.” With enhanced awareness and organizational capacity, leaders will be positioned to grow and sustain their organizations in the presence of catastrophic risk.

About the Author

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Catastrophic failures are usually exacerbated by organizational design failures, and thus are another indication of the failure of leadership. To ensure effective organizational design, Jay Galbraith's "Star Model" provides an appropriate framework for implementing the various recommendations made above. Strategic Leadership Review, Volume 1, Issue 1 ISSN: Pending CC BY-NC-ND The Dark Side of Leadership: Catastrophic Failure 28 Avoiding Catastrophic Failure Recent history provides us with numerous examples of leadership and organizational failures caused by Black Swans or Predictable Surprises.