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Avoiding the Traps That Can Cause Your Company to Self-Destruct

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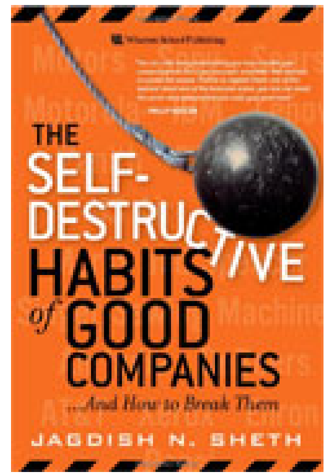

In The Self Destructive Habits of Good Companies ... And How to Break Them *(Wharton School Publishing), Jagdish N. Sheth, a marketing professor at the Goizueta Business School at Emory University, analyzes why companies that are at the top of their industry suddenly disappear from the landscape. He maintains that successful companies fall prey to complacency, arrogance, competency dependence, competitive myopia, territorial impulse, volume obsession and denial, and he then goes on to suggest ways companies can change course and avoid these traps. As Sheth notes in his introduction, "My view is that most companies can survive forever if they recognize and take steps to counter self-destructive habits or set up processes to keep them from arising in the first place." Knowledge@Wharton has excerpted a section of the book below.*

Chapter 3: Arrogance: Pride before the Fall

The standard definition of arrogance goes something like this: an offensive display of superiority or self-importance, pride, haughtiness, insolence, or disdain. Arrogance has everything to do with an inflated sense of self; it's liking the sound of your own voice too much to listen to anybody else. Arrogance is an overblown self-image that just doesn't square with the facts. In ancient Greek drama, arrogance -- or hubris -- was the "tragic flaw" that led to the downfall of great heroes. In today's world, the same flaw has caused mighty companies to stumble. Let's consider a number of scenarios that are likely to give rise to arrogance.

When Exceptional Achievement in the Past Warps Your Perception of Present Reality

Like several of the other self-destructive habits, arrogance can arise from exceptional achievement. One situation especially predictive of arrogance is when a company, through unexpected or stunning accomplishment, catapults to the position of industry leader and then goes on to successfully defend itself against wave after wave of competitive, regulatory, and even public opinion assault. Quite naturally, such a company comes to believe it is immune to external forces -- a belief bolstered by the media and its stakeholders (suppliers, dealers, and so on) --and its reputation is blown out of proportion. To me, this is the real meaning of "good to great": The company doesn't change, but its accomplishments are exaggerated by a media overly fond of big words and big stories. Gradually, the arrogance-prone company comes to believe its own press clippings. Then we have the familiar story: Success courts its own demise. For a particularly good illustration, let's look again at...

General Motors

It was under Alfred P. Sloan, who ran GM as president and then chairman for 33 years, that GM rose to the apex of American business -- and developed its culture of supreme arrogance. And why not? The company overwhelmed the competition, controlled its labor force, lobbied lawmakers, and won the hearts of consumers -- and by the early 1930s was firmly entrenched as the world's leading carmaker. By 1941, its share of the U.S. market was more than 40 percent and growing, compared with just 12 percent

20 years earlier.

As for defeating the competition, Sloan's greatest -- and most ruthless -- victory was not over Ford, nor over the foreign manufacturers he held at bay. Sloan paved the way for GM's hegemony, and for the American car culture more generally, by first utterly destroying the domestic streetcar industry. In the early 1920s only 10 percent of the population owned an automobile, and Sloan saw very clearly where his real competition lay. While he was buying up and dismantling streetcar lines, he also orchestrated a massive campaign to convince American consumers that the automobile was the form of transportation they really wanted. It was truly an arrogance-inspiring performance.

GM's attitude toward its own lower-echelon workers came to light in 1937, when assembly-line employees staged violent sit-down strikes that stalled production in Flint. Sloan wanted the governor to send in troops, but the governor demanded negotiation instead. Eventually, in 1940, a permanent agreement allowed GM workers to join the United Auto Workers, but relations between GM and its workforce remained acrimonious. According to Irving Bluestone, who directed UAW's GM department from 1970 to 1980, the syndrome at GM was not unusual for big companies during that time: that management was there to make the decisions, and workers were there to obey the decisions. "The arrogance was typical," said Bluestone, "and very deeply resented."

Perhaps the final -- and fatal -- measure of GM's arrogance came in response to the "Japanese invasion" in the 1970s and 1980s. As consumer tastes seemed to change, and as American families wanted a second car for the commute to work, GM could have tried to manufacture smaller cars that would truly compete. Instead, it made the strategic blunder of allowing its own dealers -- Pontiac, Buick, and Olds -- to carry Honda, Toyota, and Nissan. Previously, European automakers had been niche players. Even Volkswagen never gained more than 2.5 percent of the market. Why? Because of the prohibitive expense of setting up a distribution pipeline. But GM was so little concerned with the Japanese threat that it essentially gave away this tremendous competitive asset. "Who cares?" said GM. "Americans won't go for these boxy little Toyota Corollas and Datsun 210s." In effect, GM helped create the monster that would come back to terrorize it.

The rise of Toyota is just one of many examples of how the most dangerous competition comes from low-quality/low-price competitors. Utilizing price as their most tantalizing selling point, they establish a presence in the marketplace. Their upstream competitors generally malign them as easily dismissed peddlers of "junk" or just ignore them. But if these "inferior" competitors improve quality while maintaining their relative cost advantage, they become irresistible value propositions to customers. Once they have elbowed their way into the value box, they are poised to further extend their reach into the top of the market by developing highly innovative or luxury products.

For example, Honda, which was known more for its motorcycles than its cars, entered the U.S. market with the diminutive and, by U.S. standards, quirkily engineered Civic. Even its low-expectations slogan, "It will get you where you're going," appeared questionable to most American consumers. But the car quickly improved and established a solid home in the lower end of the market. Building on the Civic's success, Honda introduced the Accord, which became the wildly successful standard for value. From there, the company moved into the luxury market under the brand name Acura. Similarly, Toyota started with the Corolla, moved up to the Camry, and then took on the U.S. luxury car market with the successful entry of Lexus.

This story is repeated again and again, whether the industry is automobiles, marble and granite, leather goods, textiles, steel, semiconductors, or consumer electronics. The Korean companies Samsung and Hyundai are some of the most recent examples, and we are now beginning to hear the rumblings of multinationals in the making from emerging economies such as China, India, Brazil, Eastern Europe, and Russia.

Boeing

Boeing provides another example of how being the biggest and best produces a culture of arrogance. Founded in 1916, Bill Boeing's Boeing Airplane Company literally got off the ground with a World War I contract to build training planes for the U.S. Navy. After the war, Boeing partnered with Frederick Rentschler, developer of the air-cooled engine, to form United Aircraft and Transport, which both built and flew airplanes. The government's new antitrust rules broke the company apart in 1934, leaving Boeing Airplane with the manufacturing side of the business. But the government more than made up for that ruling by favoring Boeing with fabulously lucrative contracts during World War II -- contracts that facilitated the development of legendary aircraft like the B-17 "Flying Fortress" and the B-29 bomber. At one point the company was producing 362 planes per month for the war effort.

Boeing parlayed this bonanza into a dominant position as No. 1 in the commercial aircraft industry. Its 307 Stratoliner was the first airliner with a pressurized cabin. In 1958, it revolutionized the industry with the introduction of the 707, the first successful jetliner. The 727 and 737 followed over the next decade, cementing Boeing's position as worldwide industry leader. Indeed, no one else was really in the game. With its purchase of McDonnell Douglas in 1997 for $16 billion, it became the No. 1 military aircraft maker as well -- or, to put it more grandly, the world's largest aerospace company.

In case you're wondering, the Federal Trade Commission happily signed off on the deal, noting that McDonnell wasn't an effective competitor for commercial jet orders anymore. But opposition to the deal came from the European Commission, which threatened a trade war unless Boeing offered some concessions. The most important concession was the termination of the 20-year deals Boeing had just signed to be the exclusive provider for three major airlines: Delta, American, and Continental. A door was opened, but we'll come back to that.

As it tried to absorb McDonnell Douglas (and Rockwell, which it had bought in 1996), the giant company so accustomed to having its own way began to falter. In an agreement with the Department of Labor in 1999, Boeing acknowledged having underpaid women and minority executives and forfeited $4.5 million in back wages and raises to settle the claims. A year earlier, the company agreed to a $15 million settlement of two class-action lawsuits involving current and former African-American employees. The company's hometown newspaper, the *Seattle Times*, speculated that Boeing was having difficulty changing a culture "that many employees regarded as intimidating." At the same time, a Boeing engineer and board member of the company's second-largest union told the *Times* that Boeing's luster was on the wane. "Attrition has reached historic highs, especially among experienced and valued employees. Morale survey scores have dropped precipitously. Layoffs and shifting work packages have instilled a pervasive sense of insecurity."

Boeing also stumbled financially after the merger, losing $3 billion in costs related to airliner production backlogs. Harry Stonecipher had been CEO of McDonnell Douglas and was named Boeing Vice Chairman after the merger. He was credited with the hard-nosed leadership necessary to clean up the mess and refocus the company on the bottom line. His work apparently completed, Stonecipher stepped down in 2002, leaving Chairman Phil Condit in sole control of the company.

That arrangement didn't last long, however. The following year, allegations surfaced that Boeing tried to hire a Pentagon official before the official left office. It was also alleged that the same official may have provided Boeing inside information on a huge contract for 100 refueling tanker aircraft for the Air Force. Boeing fired its chief financial officer, Michael Sears, and Condit resigned from the company. Stonecipher, who had remained on the board, was named the new chief executive. This particular plotline ended with its own ironic twist in March 2005. Stonecipher was forced to resign when an internal investigation revealed that he had been having an extramarital affair with another Boeing executive.

Now let's go back to 1996, and even earlier, to examine the seeds of the dispute between Boeing and the European Commission. We need to begin with the history of Airbus Industrie because Boeing's arrogance has been most damaging in its competition with this European rival. Like the American automotive giants in the face of the Japanese invasion, Boeing couldn't believe that its utter dominance in aircraft manufacturing might be challenged.

The product of a French-German-Spanish-British conglomerate, Airbus was formed in 1970 with the clear intent of breaking Boeing's hegemony. With plenty of help from all four European governments, Airbus quickly began to develop into a competitor. Boeing opened its sleepy eyes in 1992, when it petitioned the European Union to set restraints on its lavish subsidies to Airbus. Europe agreed to limit the subsidies, but the agreement stipulated that Airbus would still receive generous government loans to launch new aircraft.

We begin to see Airbus's strategy in protesting the Boeing-McDonnell Douglas merger in 1996. It claimed the deal would give Boeing an unfair monopoly, but Airbus's share of the world market was already 35 percent, and the 5 percent that McDonnell Douglas represented would not really make Boeing significantly bigger. Airbus wanted other concessions. It wanted out of the 1992 agreement. More urgently, it wanted to overturn Boeing's 20-year contracts with Delta, American, and Continental. In the meantime, it began to work its way into the U.S. market by offering sweet deals to carriers in financial trouble. United, America West, and Northwest all came under contract to buy Airbus planes.

In Europe, government support made certain that Airbus's share kept growing. But the company scored a coup in 1999 when it won the JetBlue contract -- its first in the low-fare sector. Then Britain's easyJet switched from Boeing to Airbus with an order for 120 passenger jets. The vast Asian market lay on the horizon. In 2003, the unthinkable happened. While Boeing announced it would scale back production for the year to 280 planes, Airbus held firm to its projection schedule of 300, giving it a legitimate claim to the title of "world's biggest aircraft manufacturer." In 2004, Airbus reported 366 net airliner orders compared to Boeing's 272. What happened?

As *Fortune* reported near the end of 2003, part of Airbus's heady climb to the top could be attributed to its youthful advantage of being nimble and different, unhindered by old ways of doing business. Boeing's outdated production system harkened back to World War II. An even bigger problem was that Boeing couldn't duplicate Airbus's innovations -- "such as wider fuselages, cockpits designed for use in more than one aircraft, and electrical rather than mechanical flight controls -- without redesigning its aircraft at prohibitive cost." Boeing fell asleep at the controls, lulled by its longtime and overwhelming market dominance.

Even Harry Stonecipher, coming from McDonnell Douglas at a time when Boeing's position was beginning to erode, blamed the company's problems on its "arrogant and insular" culture. Ironically, noted *Fortune*, not even Airbus's victory seemed capable of jolting the sluggish behemoth. Boeing had long treated Airbus as an upstart that existed only because of government subsidies, rather than as a threatening competitor. It's true, says the magazine, that Airbus would never have gotten off the ground without government help, but Boeing had its own consistent flow of goodies from Washington. "The larger truth, though, is that Airbus is building more planes that airlines want to buy than Boeing is."

Like denial, arrogance has a way of shielding corporate eyes from such elemental truths, and Airbus continued to steal the march in 2005. With its parent enjoying record profits, Airbus again beat Boeing in total commercial orders and even put itself in contention for the Pentagon's huge order for refueling tankers. But Boeing may be waking up. As of early 2006, orders for its new 787 Dreamliner were outpacing those for Airbus's new A350, and in the long-range market Boeing's more-efficient two-engine 777 was outselling Airbus's four-engine A340. Moreover, Boeing's willingness to accede to a request from Emirates Airlines (for whose business it is competing fiercely with Airbus) to create a special redesign of the 787 may be an even clearer sign of nascent humility.

When David Conquers Goliath

A second scenario likely to give rise to arrogance is when the new kid in school beats up the playground bully -- or when the new entrant in an industry knocks the mighty incumbent off the throne. The tech sector is full of these "David and Goliath" stories, and one of the best, of course, is...

Microsoft

In its response to an unending stream of antitrust litigation -- both in the U.S. and abroad -- Microsoft has displayed the arrogance of a monopolist. The company is now the Goliath of the technology world, but let's recall when Microsoft was the puny David.

It's interesting to listen to college dropouts Bill Gates and Paul Allen talk about their early days together. How their friendship began when the "mothers' club" raised the money to put a computer in their high school in 1968. How they then began hanging out at the commercial computer center in town, where they didn't have to pay for computer time as long as they found bugs in the system and reported them. How they designed their first computer to do traffic-volume-count analysis and called their first company Traf-O-Data. How they tweaked the BASIC language they had used for Traf-O-Data and licensed it to

MIT for the Altair minicomputer. How the credit line on that first product read "Micro-Soft Basic: Bill Gates wrote a lot of stuff; Paul Allen wrote some other stuff."

They were David. IBM was Goliath. But instead of killing off the young upstart, Goliath came calling. It was 1980, and IBM was looking for programming languages for its secret PC project. Gates and Allen were willing to sell, but as negotiations continued, IBM expressed an interest in acquiring an operating system as well. Microsoft hadn't developed one, but as it happened, Allen was at that same time in the process of buying a system called Q-DOS ("quick and dirty operating system") from a little local company called Seattle Computer. Allen did the deal (for $50,000), and then he and Gates renamed the product MS-DOS and licensed it to IBM.

Even then, David was loading his slingshot. Gates remembers that IBM didn't really pay them that much. "But we knew there were going to be clones of the IBM PC. We structured that original contract to allow them. It was a key point in our negotiations." What's more, IBM was covering all the bases by also offering a version of its PC with the rival CP/M operating system, which had the advantage of being established on other PC brands. Here's where Gates and Allen whetted their appetite for battle. To make MS-DOS the operating system of choice, they promoted their product vigorously and urged other software companies to write applications for DOS first. Within a year, DOS ruled -- just as the first of what would become a tidal wave of PC clones began to flood the marketplace.

It didn't take long for Microsoft to begin to wield its monopoly power. I often like to say that Bill Gates is the reincarnation of Tom Watson Sr., a similarly ruthless entrepreneur. (I should note here that throughout this book I want to show how the self-destructive habits afflict institutions and institutional cultures, rather than individuals or individual founders or leaders. But in the case of Microsoft, a still relatively young company with its original founder still in control, it is impossible to separate the company culture from the individual.)

Apple hauled Microsoft into court in 1988 in what was then the most complicated software copyright lawsuit to date, but which was just the beginning of Microsoft's legal entanglements. Had Microsoft's Windows 2.0 stolen the "look and feel" of Apple's Macintosh operating system, as Apple claimed? Was the "look and feel," taken as a whole, protected by copyright? After four years of deliberation, the court answered "no" to both questions. The decision was upheld on appeal in 1994, and a further appeal by Apple to the Supreme Court was denied. Did Microsoft get away with murder? It's not for me to dispute the court's ruling. But it's interesting to note that Apple, once the world's top PC maker, has been relegated to niche status, selling its machines to a devoted cult of desktop publishers and graphic designers. (But stay tuned: the success of Apple's iPod music player has Microsoft mulling an alliance with Sony.)

With the arrival of the Internet, Microsoft's tactics became more brazen. Initially, Gates failed to see the Internet's full potential. He believed that closed dial-up services like CompuServe and Microsoft's MSN would prevail. As journalist Joe Breen puts it, "He was wrong, and, in 1994, an upstart Silicon Valley company called Netscape, with its Navigator browser software, rubbed his nose in it." In response, Microsoft developed its Explorer browser. It was by no means a superior product, but the price was right. It was bundled free with Windows, and thus it appeared on the desktop of every new PC. Netscape, which charged for its software, obviously couldn't compete. The Department of Justice challenged the move, arguing that Microsoft was using the market dominance of one of its products, its operating system, to muscle in on the market for another, Internet browsers. Microsoft argued that it was simply giving added value to the consumer. Thus the stage was set for the -litigation we described in Chapter 1, which Joe Breen calls "the mother of all antitrust suits."

We know how that case turned out, how Judge Jackson ruled that Microsoft should be broken up, and how his ruling was overturned on appeal. But Microsoft wasn't winning any friends. We noted Paul Krugman's comments in *The New York Times* that even as the settlement was being worked out, Gates and Ballmer were still up to their old tricks, displaying the same arrogance that got them into trouble in the first place. Even harsher was the judgment of another *Times* columnist, Pulitzer Prize winner (and globalism advocate) Thomas Friedman.

Viewing Jackson's ruling as an indictment of the high-tech's general arrogance and contempt for government, Friedman wrote that "no one epitomizes this attitude more than Bill Gates." As far as

Friedman was concerned, Microsoft's hiring of an "army of Washington lobbyists" to try to persuade Congress to slash the budget of the Justice Department's Antitrust Division while its case was before the department was more than enough reason for the government to break up the company. "Think about the arrogance behind that strategy." As a comparison, he asked readers to imagine how they would feel if the biggest company in town tried to use its influence to slash the budget of the police department at a time when the police were investigating the company.

Looking back on the case in July 2000, Judge Jackson told Ken Auletta, who was writing a book about the case, that he might now propose a new remedy for Gates. He would require the Microsoft leader to write a review of a recent biography of Napoleon. Why? "Because I think he has a Napoleonic concept of himself and his company. An arrogance which derives from power and unalloyed success, with no leavening hard experience, no reverses."

Another battle looms. At the World Economic Forum in Davos, Switzerland, in January 2004, Gates made a surprising confession: "Google whipped our butts." The last entity to whip Microsoft's butt was Netscape. Now Microsoft is touting Vista (formerly code-named Project Longhorn), the long-awaited replacement for Windows XP that is loaded with new programs and features. It includes integrated search technology for finding and organizing information, whether it is on the Internet or in the user's own e-mails and files. Can Microsoft make its own search technology the default? Will Google be "Netscaped"? Anticipating the battle, Google has launched "Gmail," its own e-mail service that will allow users to store the equivalent of 500,000 pages of e-mail for free.

Google is already huge. This may be a fight between Goliath and Godzilla.