



ETHICAL LEADERSHIP AND LEADER MEMBER EXCHANGE (LMX) THEORY

BASED ON A CASE STUDY IBM "LEADING THE TURNAROUND"

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The aim of this paper is to evaluate the contribution that developments in the area of ethical leadership and trust have made to our understanding of effective people management within organisations. This paper is based on a case study from Harvard Business Review (2007) called "IBM - Leading the Turnaround". The author will use Leader Member Exchange (LMX) theory by Graen and Uhl-Bien (1995) and integrate the ideas of ethical leadership to critically evaluate the leadership style of the CEO of IBM Louis V. Gerstner that led to the turnaround of IBM. In particular, the author will focus on the following question: What role did trust play in the leadership style of Gerstner in the transformation of IBM?

When Gerstner became the CEO of IBM in 1993, an \$8.1 billion loss on the stock market was announced by IBM; this was one of the largest in U.S. history. Gerstner was facing a difficult job as stock market commentators were rapidly writing off IBM as a 'slow elephant' and, as a result, IBM's workforce was not in any state to accept change. Gerstner's first task was to analyse what was going wrong within IBM, despite having dedicated people, high technological infrastructure, and a sound strategy, he found that IBM was suffering from its own success during the many years of operation. Its own success was its downfall, for it had become slow moving and inward looking.

Organisationally, it had become a decentralised 'kingdom' in which none of the business units communicated with each other. Gerstner realised that, if IBM was to be saved, he had to lead this massive organisation through cultural change. He realised that changing the attitude and behaviour of thousands of people was hard to accomplish, but was the main key to success. Management could not change organisational culture through words and policies alone; leaders such as Gerstner had to create the conditions for transformation and invite employees to respond willingly.

IBM had a tradition of appointing executives from within. Indeed, Gerstner was the first CEO to be hired from outside; this in itself was revolutionary and created widespread internal concern. Before Gerstner arrived, it was accepted that the break-up of IBM was inevitable. The question was only what form this would take. Morale was at rock-bottom, and Gerstner's appointment did nothing to raise spirits. It was assumed he had been brought in to 'wield the hatchet'.

Therefore, it was a real surprise when Gerstner made himself open to input from anyone in the company. It was even more surprising when he announced that IBM's strength lay in its integration and that there would be no break-up. Immediately spirits started to soar. Everyone knew there would be a pain, but now it seemed it would be on a much lower level, and employees were prepared to listen for a change. While it took time to build trust, Gerstner's no-nonsense style created confidence that someone was in charge. His actions were not popular, but they were decisive. It was this that steadily led to a sense of trust; he did what he said he would do, and he proved himself trustworthy.

In the next section, the author will provide a background to leader-member exchange (LMX) theory and relate it to ethical leadership so that we can explore the leadership style of Gerstner during the change at IBM.

LEADER MEMBER EXCHANGE (LMX) THEORY AND ETHICAL LEADERSHIP

Leader-member exchange (LMX) theory by Graen and Uhl-Bien (1995) focuses on the relationship between the leader and member. The key principle of LMX theory is that leaders develop different types of exchange relationships with their followers and the quality of the relationship that is developed alters the impact on outcomes of this leader and member exchange. Therefore, according to LMX theory, leadership occurs when leaders and followers are able to develop effective relationships that result in mutual influence (Uhl-Bien, 2006).

Leadership can be described as a process that involves several factors; one of these could be the ability to influence others and motivate them to reach a common oriented goal, like the change required at IBM (Northouse, 2007, pp. 2-9). This would require leadership changes that foster relationships and accompany ethical burdens and responsibilities, as making a change in people may influence not only their working lives, but also the lives of people around them. Trust, therefore, plays a central role in developing relationships with employees during the process of change management.

LMX theory explores how leaders and managers develop relationships with team members, and it explains how those relationships can either contribute to the growth and assist change or hold people back in the leadership context. In LMX theory trust is described as a leader's authentic behaviour, a leader's trustworthy behaviour and how it is implemented in daily actions are key components of LMX exchanges.

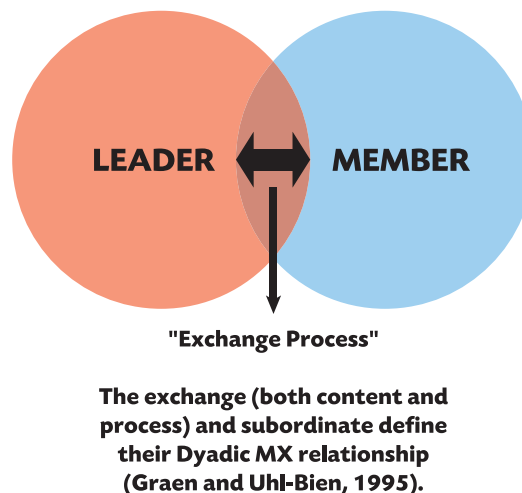


Figure 1: LMX model illustrating the exchange process

The LMX process is based on the assumption that leaders pay attention to the traits, skills and competencies of their followers during the exchange process (Figure 1) and assess whether they are competent and effective to take care of a certain position or work in the organisation. From the perspective of the follower, the main question is how trustworthy the leader is.

According to Graen and Uhl-Bien (1995) researchers have found that high-quality leader-member exchanges produce less employee de-motivation and greater organisation commitment. Graen and Uhl-Bien have also suggested that leadership making develops progressively over time in three phases: (1) the stranger phase, (2) the acquaintance phase, and (3) the mature partnership phase. During the final phase (3), the mature partnership relationship is marked by high-quality leader-member exchanges that involve a high degree of mutual trust, respect, and obligation towards each other. Such high quality relationships will produce high LMX during the transformational leadership phase such as the one faced at IBM.

The quality of the exchange process will, therefore, depend upon the qualitative characteristics of the exchange between leader and member. Such qualitative characteristics could be 'ethical values' and trust will play a major role in this process. Such 'ethical values' can be considered as qualitative characteristics that create high LMX in transformational leadership. We could say that 'ethical value' congruence between the leader and the member could be defined as the degree of agreement between the leader's value system and the member's value system, a high degree of agreement would point towards a high LMX.

Weiss (1978, pp. 711-718) has found that people aligned their values with the values of their leader if they perceived their leader as trustful. Leaders, therefore, have an ethical responsibility and one of the characteristics that exercise such responsibilities are accommodating the value systems of the members in the leadership process. According to Beauchamp and Bowie (1988), this requires the essential ability of leaders to be sensitive to the interests and concerns of others.

With such an attentive attitude, an ethical leader may foster change in others and lead people towards change in an organisation similar to the one required at IBM. Heifetz (1994) states that in order for such effective changes to occur successfully, leaders have to exercise their authority with a notion of responsibility, a responsibility that requires respect for the prospective change in others. Heifetz (1994) calls this a "holding environment" where trust, nurturance, and empathy are exercised with the aim of change. Such a change would generally be resisted; however, Heifetz (1994) says that in such a "supportive context" followers would generally feel secure to face the hurdles of change more effectively and to manage issues that may arise. During the change at IBM, Gerstner was instrumental in changing the mental orientation of his employees from a self-centric to a customer-centric point of view. Initially, this was resisted, and he had to develop an environment of "supportive context" where employees would trust the leader (Heifetz, 1994).

Therefore, he used his authority and got employees to pay attention to the issues facing IBM. He recognised the values in others and identified the changes required so that conflicting values would be reduced during the high congruence process that led to a high LMX. As Heifetz (1994) says, Gerstner recognised the benefits of the existing environment at IBM and utilised the importance of trust in a "supportive context" where employees would feel safe to confront any hurdles the process of change.

So, for a transformational leader to lead change effectively, the needs, values, and moral of employees have to be at the forefront. Burns (1978) in his theory of transformational leadership emphasises that a transformational leadership requires a focus by leaders to assist employees to higher standards of moral responsibility. He states that leadership has a moral dimension, and he characterises this as ethical leadership. He stresses that leaders need to engage themselves with employees and assist them in their personal struggles concerning conflicting values so that these are aligned with organisational values in the process of effective change. It is, therefore, the responsibility of the leader to assist employees in the assessment of their own values and through trust align these values with organisation values in the process of change, this "connection", Burn (1978) says, that raises the level of morality in both the leader and the employee and develops trust, an essential element of ethical leadership.

As a transformational ethical leader, according to Bass (1985), Gerstner led to initiate change at several business processes within IBM, and these processes of change were not easy to implement for a company that has been described as moving like a "slow elephant". Gerstner had to initiate specific conditions for this transformation and for employees to respond to these necessary changes. Some of these changes were to gain the support of major customers by establishing credibility, comparing expense to revenue of IBM with those of leading competitors in the market to monitor expense reduction, re-engineer business processes at IBM to reduce overheads, and sell off unproductive assets.



Figure 2. Trust and the principles of leadership.

In order to carry out these changes, Burns (1978) stresses that ethical leadership requires engagement with employees, and this process of engagement requires the identification of personal values and realigning them with changing corporate values, a process that would create a high degree of congruence in aligned ethical values and therefore a high LMX. Such a process involves several stages where the leader has to recognise the importance of personal values, develop a level of trust in the managers' abilities to change and communicate the importance of realigned corporate values. Burns emphasises that when such a process works effectively, the leader attends to the personal motivations of the managers and re-directs them to a better set of moral values that are congruent with corporate values.

In many ways, one can note a common theme running through the different perspectives of ethical leadership and its relationship with LMX theory presented in the last section, the main ones being that a high quality leader-member engagement is essential to ethical leadership. It is also essential for ethical leaders to pay close attention to the needs of their employees; these leadership theories are similar to those presented in the "Ethics of Caring" by Gilligan (1982). Gilligan emphasises five key principles relating to ethical leadership with the origins of these can being traced back to the works of Aristotle. These principles provide the foundation for the development of ethical leadership traits; these principles are respect, service, justice, honesty, and community.

These are shown in Figure 1 which has been adapted from Northouse (2007). Briefly discussing each of these traits, we see that leaders who respect others, approach people with trust, and acknowledge others' values and ideas. Leaders who exercise this trait in their leadership are seen as providing service towards others; they are considered as altruistic and are placing their followers' welfare as a priority in their plans to implement change. This service trait has been emphasised by several authors on ethical leadership maintaining that attending to the service of others, and developing trust is the primary building blocks of ethical leadership.

The importance of these traits can also be seen in the works of Senge (1990). In his work on learning organisations, Senge emphasises that one of the most important tasks for a leader in learning organisations is the stewardship role; the steward (servant), or the visionary of change, directs implementation during the change process. This viewpoint has the characteristics of not being self-centered; it involves a deliberate step taken by the leader with a motive of integrating one's vision with that of others in the organisation. Senge, therefore, stresses that ethical leadership concerns itself with fairness and justice, with fairness playing a role in integrating personal values with organisational values and justice demanding that the leader place issues of fairness as a motive of their decision making.

Here we may look to the works of Beauchamp and Bowie (1998), who have outlined principles that may guide an ethical leader in distributing the benefits and burdens relating to transformational change fairly.

The fourth principle of ethical leadership relates to the manifestation of honesty in an ethical leader. For Gerstner, the communication of change at IBM was not an easy task; he had to represent the reality of the situation at IBM and the challenge for him was to strike a balance between being truthful and to monitor what information to disclose in particular stages of the transformation at IBM.

Dalla Costa (1998) makes this point clearly in his book "The Ethical Imperative" where he states that "being honest" is more than just "not deceiving"; for an ethical leader, Della Costa points out that being honest is governed by the characteristics such as to not promise what you cannot deliver, not misrepresent information, not suppress obligations, not to reject accountability, and not openly accept that the competitive pressures of business are an open reason to release our responsibility towards the respect and dignity of others. Burns (1978) placed this characteristic of honesty at the centre of his theory of transformational leadership. With the exercise of these four principles, the ethical leader, therefore, fosters a community, a community created with belonging that has the characteristics of trust placed in the ethical leader, a community that is bonded together and believes in the vision of the transformational leader such as Gerstner. One of the eight principles that Gerstner developed at IBM to transform employees' beliefs was that outstanding dedicated people make it all happen, particularly when the work together as a team.

THE ROLE OF TRUST IN HIGH LMX EXCHANGES

Central to these five principles of leadership is the role that trust has to play in each one of them. The five principles of leadership presented in Figure 1 represent actions that an ethical leader follows as part of his/her character. These actions can cause successful change when the leader has developed trust. For example, respect of others can be exercised successfully only if the other person respects and trusts the leader in the first place. Similar arguments can be applied for the other four principles of ethical leadership.

Gerstner at IBM exercised these five principles of ethical leadership to bring about transformational change, and he was trusted as a leader and his team had confidence in what he was planning. We can use the model of ethical leadership from Northouse (2007) and adapt it with the idea of trust as developed by the author and see how this change was achieved at IBM. This can be seen in Figure 3, which shows how Gerstner as a leader led IBM through the necessary transformational changes.

The main component that functions actively through the five ethical leadership traits is the notion of trust. When you trust someone, or someone trusts you, things can move more quickly and effectively. Less obvious, but not less important, are the benefits of trusting others which are the abilities to trust customers for greater efficiency and creativity in serving them.

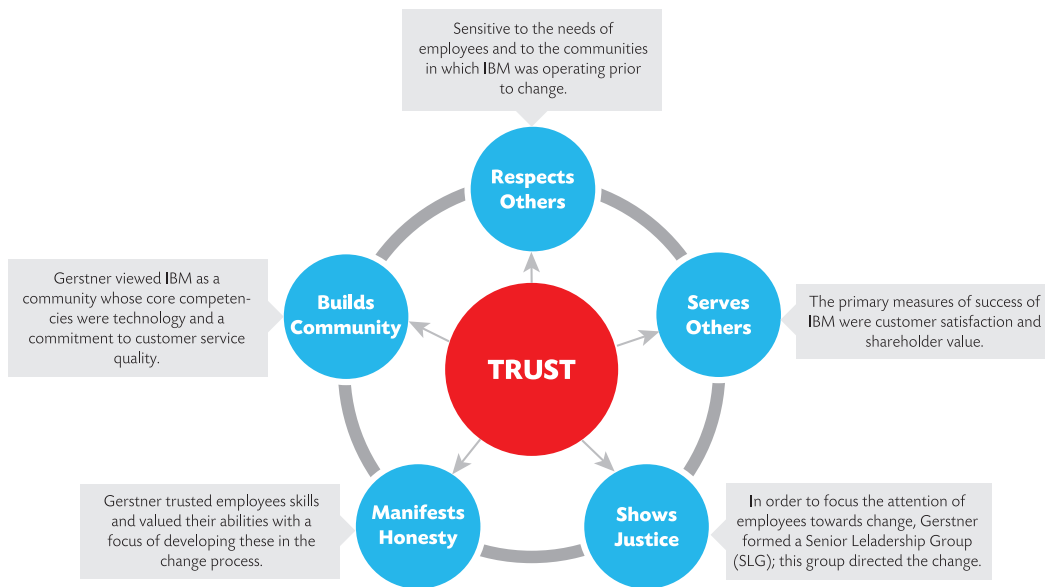


Figure 3. Relationship of the Ethical Leadership and Trust Model to change at IBM led by Gerstner.

We note that Gerstner would not have been able to lead with trust unless he was personally trustworthy and capable of trusting. A trust relationship, therefore, has three aspects: (1) two asymmetrical roles - one who trusts, another who is trusted, (2) the element of risk, and (3) reciprocating the roles of trustor and trustee.

Trust can be seen as a dance with two players: one who trusts, and one who is trusted. Most leaders and managers focus more on being trusted than on trusting. Learning to juggle these is a critical skill for ethical leadership. The best way to be trusted is to be worthy of trust, to be trustworthy. By far the most efficient and effective strategy for being trusted is to actually be trustworthy. But what does that mean? One thing it means is actively exercising certain personal traits. Whether from habit or personality, personal traits are what allow others to consider us trustworthy or not. We will use the term 'virtues' to describe these traits. It implies a consistency of character that provides a guidepost for the individual, and that can be relied upon by others. It may not be absolute, but we expect it to withstand some level of incentives, group pressure, or business process. A virtue is something that we see as getting to the heart of a person.

According to Maister, Green and Galford (2000), there are four such traits: credibility, reliability, intimacy, and (low) self orientation; they can be expressed, on a scale of 1 to 10, in the form of an equation, the Trustworthiness Equation, and they cover most of the usages of "trustworthiness" in common and business language, as well as across cultures. The Trust Equation arrays the four virtues in the form of an equation. This format allows for discussion about interplay and impact though should not be taken too literally as a description of something that exists outside the model.

The trustworthiness equation is:

$$\text{Trustworthiness} = \frac{\text{Credibility} + \text{Reliability} + \text{Intimacy}}{\text{Self Orientation}}$$

Credibility is largely about words. We might say; I can trust what she says about this issue, meaning we recognise her degree or her credentials, her statements are logical, she uses recognised means of communication, there are no spelling errors in her resume, and so forth.

Reliability applies more to actions. We might say; I can trust him to do (whatever he said he would do), meaning he is dependable, predictable, a person of integrity; someone who honours his word, and if he cannot honour it, takes immediate responsibility for it. Reliability is only trust equation component that literally requires time, because it requires repeated experiences which happen over time.

Intimacy refers to a sense of security. We might say, I trust her with this information, meaning she is sensitive to our needs, knows when and to whom to pass information along, and knows just how to treat it.

Self-Orientation is in the denominator of a trust equation, high levels of self-orientation mean low level of trustworthiness. High self-orientation comes in two forms: selfishness and self obsession; the latter is less obvious, therefore, more pernicious in business.

Any interaction with another human being is a potential source of fear, thus of fight or flight, but also an opportunity to behave differently, in ways that create trust. Overcoming self-orientation is not a business process, an analytic, or even a skill such as practicing tennis or a golf shot. It is a self-willed psychological state in which we are ego-comfortable enough with our own selves to relate to others without fear or desire to control.

The role that trust has to play in ethical leadership is, therefore, a crucial element in the overall character of the ethical leader bringing about transformational change in any organisation. Credibility, reliability, intimacy and self-orientation are, therefore, important variables that define trustworthiness in its relationship together with the key factors of ethical leadership defined in Figure 4.

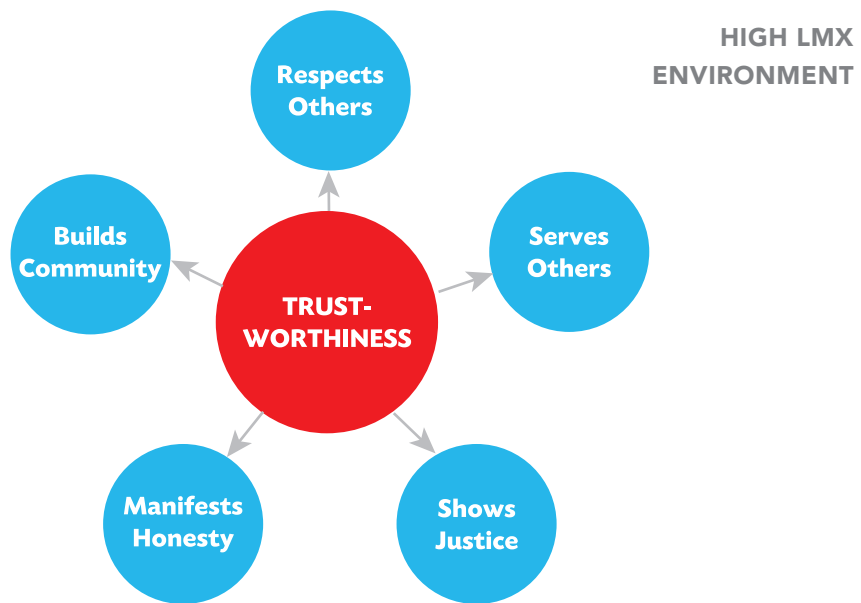


Figure 4: Illustrating Ethical Leadership, Trustworthiness and LMX Relationships

LMX and ethical leadership theories make several positive contributions to our understanding of the leadership process carried out by Gerstner at IBM. LXM theory uses the dyadic exchange relationship as the main leadership process and emphasise that effective leadership is contingent on effective leader-member exchanges. The author has attempted to add content to this effective leader-member exchange by using the model of ethical leadership and trust. LMX theory is also related to positive organisational outcomes, and in a review of their research Graen and Uhl-Bien (1995) point out that it is related to performance, organisational commitment, and many other important organisational variables. One of the criticisms of LMX theory is that the basic ideas of the theory are not yet fully developed. For example, it fails to explain how high-quality leader-member exchanges are created, trust and trustworthiness may play key roles, as explained above, however, the role of different cultural values and abilities of different people to acquire the ethical values is not really researched. There is also the problem of measurement of leader-member exchanges in LMX theory by Graen and Uhl-Bien (1995) and Schriesheim et al. (2001). No empirical studies have been carried out that use dyadic measures to analyse the LMX process and its effectiveness with the ethical leadership model and further investigate the role of trust.

CONCLUSION

To conclude this paper, the author has attempted to explain the leadership process carried out at IBM during the change management process using the LMX leadership model. This model was developed further by the author to explain the importance of ethical leadership together with the notion of trust. Trust was incorporated within the ethical leadership model adopted from Northouse (2007) to integrate it with the LMX leadership process. In doing this, the transformational change that was implemented by Gerstner at IBM was taken as an example of a practical ethical leader creating a high LMX. The emphasis has been to develop the LMX model further by the application of ethical leadership theories to the IBM case study on transformational change and to critically develop a discussion that shows the importance of trust in the transformational leader leading change at IBM. ■

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APPENDIX 1 - CASE STUDY

LEADING THE TURNAROUND: LOU GERSTNER OF IBM

By Paul Sheppard, Wharton MBA Student and Deputy Editor, Wharton Leadership Digest



Lou Gerstner, retired Chairman and CEO of IBM, recently spoke at Wharton about his experience of leading one of the most celebrated turnarounds in corporate history.

In a pragmatic and modest speech, Gerstner was weary of drawing platitudes of leadership that could be applied to every situation. Rather he wanted to describe what happened at IBM and draw lessons from it.

When Gerstner took over in 1993, IBM had just announced a \$8.1 billion loss; the largest in US history. He had 100 days of cash left and IBM was already being written off by commentators as a dinosaur and an also-ran. Not surprisingly, IBM's workforce was demoralized and hostile.

Gerstner's first task was to analyze the problem. Despite having good people, great technology and a sound strategy, he found that IBM was suffering from a "success syndrome." Gerstner described IBM in the 1960s, 70s and 80s as "the greatest commercial institution ever created." But instead of continuing to build on this legacy, it had become insular, inward-looking and rigid.

Organizationally, it had become a decentralized fiefdom in which none of the business units communicated with each other. Gerstner realized that his overarching task was to lead a massive organizational and cultural change.

Gerstner quickly found ways to stop bleeding cash and identified the company's principal growth engines. He wanted to break the assumption that customers would always buy IBM because of its past achievements. He then started to rebuild the company around the customer.

To reintegrate the organization, he sought to provide total solutions to customers. To do so, he needed to transform almost every business process conducted by IBM. He cautioned his audience of star struck MBAs that managing a complete turnaround was not as glamorous as they might think. He quoted one of his senior managers who likened the implementation of the reengineering process to going to work every day and "setting your hair alight and then putting it out with a hammer."

Painful as the process was, it was successful. The business units had been reintegrated and Gerstner made \$14 billion of cost savings. Gerstner said that he learnt three fundamental lessons from his time at IBM; the importance of:

1. Focus. Gerstner stressed the how imperative it was for a leader to love their business and to "kill yourself to make it successful." There is no substitute for hard work and the desire to win. CEOs face a multitude of choices, often peddled by a multitude of self-interested advisors, but they need to focus on exploiting competitive advantages in core businesses. Accordingly, it is the CEO's responsibility to manage consultants, investment bankers and advertising agencies so to best serve their business rather than let them set the agenda.

- 2.** Execution. Gerstner said that execution is what really separates business leaders. As an ex-McKinsey Director, Gerstner said that consultants' "dirty little secret" was that it is not that difficult to come up with attractive strategies in public markets in which everyone has good information. The true differentiator was how you implement them.
- 3.** Personal leadership. Gerstner said that despite the volumes of business books written on leadership recently, he still thought that this was the most undervalued element of institutional change. When asked later for his advice of how MBA graduates should behave to strive to emulate his success, Gerstner said that as a start you should always strive to do the job you are doing better than the guy before you.

Finally, Gerstner wanted to discuss the importance and challenges of transforming corporate culture. For him, institutional culture is not what is said but it what is done. As an example of cultural change, Gerstner discussed abolishing IBM's notorious dress code. He said that at the time the public reception was as if he "had sold the company to the Russians." But for Gerstner, it was common sense for IBM's salesmen to dress as their customers were doing.

Gerstner said that changing the attitude and behavior of thousands of people is hard to accomplish but key to success. The work environment is the crucible for individuals' productivity. Management cannot change culture through words and policies alone. All leaders can do is create the conditions for transformation and invite employees to respond. Not surprisingly, he attributed IBM's success to the thousands of employees who were willing to react to his initiatives and work hard to make the elephant dance again.