CURRENCY

THE VOLKSWAGEN SETTLEMENT: HOW BAD MANAGEMENT LEADS TO BIG PUNISHMENT

By Jeffrey Rothfeder, JULY 1, 2016

As striking as some of the details in the Volkswagen settlement are, the scandal shouldn't have been surprising.

By many critical measures, the Justice Department's announcement on Tuesday that Volkswagen had agreed to pay $14.7 billion to resolve claims related to its diesel-emissions scandal was startling. For one thing, it is the largest class-action settlement ever, billions more than the one Enron agreed to in 2008. It also far exceeds Toyota's $1.1 billion outlay, in 2012, over flawed accelerators, and the two billion dollars that General Motors recently agreed to pay for faulty ignition switches.

The Volkswagen agreement calls for a record product buyback, which will require the company to repurchase from consumers, at market price, as many as four hundred and seventy thousand or so automobiles with model years 2009 through 2015, which came equipped with stealth software capable of masking, during testing, their engines' ability to emit up to forty times the legally permitted levels of nitrogen oxide. In addition, as part of the settlement, Volkswagen will have to pay billions to support various pollution-control projects, the largest punishment ever meted out under the Clean Air Act.

As if to punctuate the scale of Volkswagen's perfidy, Deputy Attorney General Sally Yates announced the settlement in language dripping with the kind of disdain usually reserved for organized crime figures. "Volkswagen turned nearly half a million American drivers into unwitting accomplices in an unprecedented assault on our environment," she said.

Still, as striking as some of the details of the settlement are, the scandal shouldn't have been surprising. For decades, Volkswagen has practiced a management style that imposes rigid goals and punishes middle- and lower-level employees who are unable to keep up with the pace. The origins of this approach, known as top-down control, date back more than a century, to the work of the industrial-efficiency guru Frederick Winslow Taylor. In its current iteration, the concept typically sees executives formulate bold strategic objectives and timelines for new products and services, with little input from others in the company. Although these aims are often presented as guidelines, not mandates, management rarely treats them as negotiable. In turn, rank-and-file employees, pressured by the expectations placed on them, try to deliver at all costs.

Although top-down culture is increasingly being discredited in favor of greater organizational coöperation and worker empowerment, it is still prevalent, embraced to varying degrees by big names like Apple, Nissan, General Electric, and Boeing. In some cases, it has been costly: while reporting a feature on Boeing for *Portfolio* magazine some years ago, I observed that the company's difficulties in getting its vaunted Dreamliner off the ground were directly related to the "aggressive goals-fearful employee" dynamic. Numerous experts whom I spoke with about Volkswagen agreed that few other companies apply top-down control so unremittingly, and that this was the likeliest explanation for why its engineers were willing to commit crimes and defraud the public to save their jobs. As one person who had worked closely with Volkswagen told me, the company "is fuelled by intimidation at every level, which creates a borderline, or sometimes over the borderline, unethical culture."

The groundwork for the diesel scandal at Volkswagen was laid around 2007, soon after Martin Winterkorn was named C.E.O. The auto industry was just beginning to undergo its most pronounced transformation since the days of Henry Ford, a still-evolving shift in direction away from the venerable internal-combustion engine and toward innovative concepts like electric, hydrogen, and autonomous cars. This put severe pressure on automobile manufacturers to make especially acute guesses about products and technology, by anticipating consumer preferences and policymaker demands. In the midst of this budding uncertainty, Winterkorn fashioned an ambitious growth program, Strategy 2018, whose main goal was to have the company, which was already Europe's top automaker, bypass General Motors and Toyota as the global leader by 2018. As part of this plan, Volkswagen would take a different path than other automakers, who were exploring hybrids and other eco-friendly upgrades to the internal-combustion engine, and make a huge bet on so-called clean diesel—which, its supporters argue, delivers better fuel economy than gasoline, and lower emissions, without a drop in performance.

This was a logical tactic for the European market, where diesel engines are popular and emissions standards are relatively easy to meet. But the company's engineers immediately hit a roadblock in the U.S. In 2007, the Environmental Protection Agency had implemented a set of strict pollution limits for diesel engines, and, after Barack Obama's election, tougher gas-mileage rules were imposed as well. Aaron Robinson, the West Coast editor of *Car and Driver*, has been following the scandal closely, and he told me that, in order to become the world's top car company and amortize the substantial investment that Volkswagen made in diesel research and development, the company needed to succeed in the U.S. market, where it had generally lagged. But its diesel engines weren't equipped to meet either of the new U.S. standards.

This problem was an existential dilemma for Volkswagen's engineers. Winterkorn and his marketing team were gearing up for a major advertising effort in the U.S., which would tout the environmental benefits and surprising performance of diesel vehicles. Mark Stevenson, the managing editor of the Web site The Truth About Cars, told me that this push, combined with other messages from top executives, conveyed to the engineers that getting the car right was solely their responsibility. The consultant who had worked with Volkswagen told me he'd heard from an engineer there that no one in management wanted to hear about problems they encountered, and that they feared for their jobs.

With scant technical fixes at their disposal—it would be a few more years before Volkswagen developed pollution-abatement equipment sufficient to meet the E.P.A. diesel regulations—the engineers turned to an option that they had learned about from the diesel community in Europe, a technology that was developed for emergency vehicles and off-road equipment like cranes and bulldozers. This software was permitted by regulators as a way to override pollution controls in short spurts, when high engine performance was required. But Volkswagen's engineers took the concept a step further. They expanded the software's capabilities, enabling it to detect when a stationary emissions test was taking place and alert the engine-control system to adjust catalytic converters and exhaust systems to reduce pollutants. With that deviously brilliant idea, the engineers had found a way to keep Winterkorn and the E.P.A. happy. Volkswagen sold upward of twelve million vehicles with this bit of contraband worldwide, including the roughly five hundred thousand in the U.S.

These actions were manifestations of a malady that is not unusual in companies with top-down cultures. In these environments, executives often perceive themselves and their organizations to be open and communicative hotbeds of collegiality and collaborative innovation. Organizational experts, such as Keith Ferrazzi, the author of "Who's Got Your Back," describe this as a delusion of infallibility arising from centralized power. If leaders of these companies are so adept at management—as their sweeping responsibilities indicate and as everyone in the organization appears to tell them they are—how could the lower levels of their businesses be dysfunctional?

Indeed, Volkswagen's conceit was that individual brands had autonomy, and that new ideas would bubble up from these separate groups, ultimately to be shared with other teams who would adopt them in perhaps a different form for their own purposes. But this notion, like the diesel fix itself, was a sham. Because of the pressure to meet timelines and to curry favor with higher-ups, which was the only path to promotion at the automaker, vehicle-model teams shared virtually nothing, keeping secrets about mechanical breakthroughs or new design elements from one another—even subverting one another when the opportunity arose. "Everyone in that company was adversarial," the consultant who worked with Volkswagen told me.

Volkswagen declined to comment on the specific details in this article; however, the company referred me to a speech given to shareholders in June by Matthias Müller, who was named C.E.O. last September, after Winterkorn resigned. "Our management culture needs to improve," Müller said. "Openness, the courage to make innovations and speak one's mind, as well as true willingness to coöperate are all essential elements. . . . We need a solid system of values as a compass for our daily work."

Since the diesel scandal was unearthed, last year, Volkswagen sales have plummeted in the U.S. and slowed in Europe. And the settlement with the Justice Department does not preclude almost certain additional litigation here and in Europe. This is a bad time for an auto company to be going through these troubles. In the next decade or so, spurred by a younger generation of drivers, global-warming initiatives, and fossil-fuel depletion, the shape, design, and role of the automobile will change in revolutionary ways. Typically, in times of volatility, companies with bottom-up, open-channel cultures—think Google, Southwest Airlines, and Zappos, to name a few—have succeeded, mainly because the business landscape is so inchoate that a pool of unorthodox ideas, not insularity, are required to make sense of it. For Volkswagen, whose engine-design efforts are now years behind those of other automakers, the lesson may have come too late.

Jeffrey Rothfeder is a former editor-in-chief of the International Business Times and a former national news editor at Bloomberg News. His latest book is "Driving Honda: Inside the World's Most Innovative Car Company."

MORE: POLLUTION