

depending on the model, age, and trim level (lessees would receive \$2600 to \$4900). Owners who did not sell their cars back would receive between \$5100 to \$10,000 to compensate them for diminished resale value, plus owners were entitled to have their emissions fixed for free. On January 11, 2017, the U.S. Department of Justice announced an additional \$4.3 billion in criminal and civil penalties to be paid by Volkswagen (in total the U.S. would extract roughly \$25 billion in fines from Volkswagen). Canada and South Korea would also fine the company, and though the European governments were less aggressive in seeking financial penalties, eventually Germany fined the company approximately €1.2 billion. Perhaps more significantly, a total of eight executives of Volkswagen were charged with crimes in the U.S., with several being assigned prison sentences, and Germany was investigating dozens more, leaving many wondering how far, and how high up the Volkswagen hierarchy, the punishments would go.¹²

11-1 OVERVIEW

We open this chapter with a close look at the governance mechanisms that shareholders implement to ensure that managers act in the company's interest and pursue strategies that maximize shareholder value. We also discuss how managers need to pay attention to other stakeholders such as employees, suppliers, and customers. The Opening Case shows just how dire a failure of corporate ethics and governance can become, and the Closing Case on Starbucks offers a good illustration of how some companies incorporate a wide range of stakeholder needs into their strategy. Balancing the needs of different stakeholder groups is in the long-term interests of the company's owners, its shareholders. Good governance mechanisms recognize this truth. In addition, we review the ethical implications of strategic decisions, and discuss how managers can make sure that their strategic decisions are founded upon strong ethical principles.

11-2 STAKEHOLDERS AND CORPORATE PERFORMANCE

A company's **stakeholders** are individuals or groups with an interest, claim, or stake in the company, in what it does, and in how well it performs.¹³ They include stockholders, creditors, employees, customers, the communities in which the company does business, and the general public. Stakeholders can be divided into two groups: internal stakeholders and external stakeholders (see Figure 11.1). **Internal stakeholders** are stockholders and employees, including executive officers, other managers, and board members. **External stakeholders** are all other individuals and groups that have some claim on the company. Typically, this group comprises customers, suppliers, creditors (including banks and bondholders), governments, unions, local communities, and the public.

stakeholders

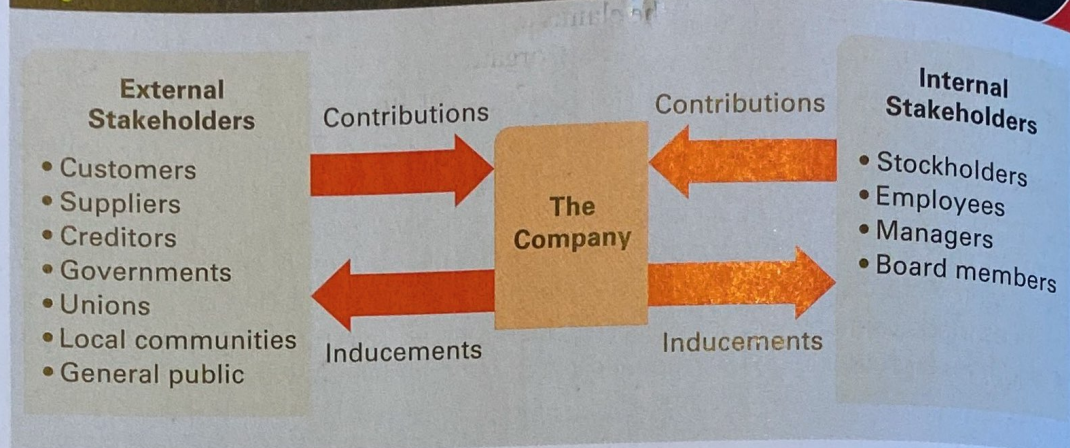
Individuals or groups with an interest, claim, or stake in the company—in what it does and in how well it performs.

internal stakeholders

Stockholders and employees, including executive officers, other managers, and board members.

external stakeholders

All other individuals and groups that have some claim on the company.

Figure 11.1 Stakeholders and the Enterprise

All stakeholders are in an exchange relationship with their company. Each stakeholder group listed in Figure 11.1 supplies the organization with important resources (or contributions), and in exchange each expects its interests to be satisfied (by inducements).¹⁴ Stockholders provide the enterprise with risk capital and expect management to attempt to maximize the return on their investment. Creditors, particularly bondholders, also provide the company with capital, in the form of debt, and they expect to be repaid on time, with interest. Employees provide labor and skills and in exchange expect commensurate income, job satisfaction, job security, and good working conditions. Customers provide a company with its revenues, and in exchange want high-quality, reliable products that represent value for money. Suppliers provide a company with inputs and in exchange seek revenues and dependable buyers. Governments provide a company with rules and regulations that govern business practice and maintain fair competition. In exchange, they want companies to adhere to these rules. Unions help to provide a company with productive employees, and in exchange they want benefits for their members in proportion to their contributions to the company. Local communities provide companies with local infrastructure, and in exchange want companies that are responsible citizens. The general public provides companies with national infrastructure, and in exchange seeks some assurance that the quality of life will be improved as a result of the company's existence.

A company must take these claims into account when formulating its strategies, or stakeholders may withdraw their support. For example, stockholders may sell their shares, bondholders may demand higher interest payments on new bonds, employees may leave their jobs, and customers may buy elsewhere. Suppliers may seek more dependable buyers, and unions may engage in disruptive labor disputes. Government may take civil or criminal action against the company and its top officers, imposing fines and, in some cases, jail terms. Communities may oppose the company's attempts to locate its facilities in their area, and the general public may form pressure groups, demanding action against companies that impair the quality of life. Any of these reactions can have a damaging impact on an enterprise. A study by Henisz, Dorobantu, and Narthey on the impact of stakeholder opposition to gold mines, for example, found that the value of cooperative relationships with external stakeholders was worth twice as much as the market value of the gold itself.¹⁵ As articulated by Yani Roditis, former COO of Gabriel Resources, "It used to be that the value of a gold mine was based on three variables: the amount of gold in the ground, the cost of extraction, and the world price of gold. Today, I can show you two mines identical on these three variables that differ in their valuation by an order of magnitude. Why? Because one has local support and the other doesn't."

11-2a Stakeholder Impact Analysis

A company cannot always satisfy the claims of all stakeholders. The goals of different groups may conflict, and, in practice, few organizations have the resources to manage all stakeholders.¹⁶ For example, union claims for higher wages can conflict with consumer demands for reasonable prices and stockholder demands for acceptable returns. Often, the company must make choices, and to do so it must identify the most important stakeholders and give highest priority to pursuing strategies that satisfy their needs. Stakeholder impact analysis can provide such identification. Typically, stakeholder impact analysis follows these steps:

1. Identify stakeholders.
2. Identify stakeholders' interests and concerns.
3. As a result, identify the claims stakeholders are likely to make on the organization.
4. Identify the stakeholders who are most important from the organization's perspective.
5. Identify the resulting strategic challenges.¹⁷

Such an analysis enables a company to identify the stakeholders most critical to its survival and to make sure that the satisfaction of their needs is paramount. Most companies that have gone through this process quickly conclude that three stakeholder groups must be satisfied above all others if a company is to survive and prosper: customers, employees, and stockholders.

11-2b The Unique Role of Stockholders

A company's stockholders are usually put in a different class from other stakeholder groups, and for good reason. Stockholders are the legal owners and the providers of **risk capital**, a major source of the capital resources that allow a company to operate. The capital that stockholders provide to a company is considered risk capital because there is no guarantee that stockholders will recoup their investments and/or earn a decent return.

Recent history demonstrates all too clearly the nature of risk capital. For example, many investors who bought shares in Washington Mutual, the large, Seattle-based bank and home loan lender, believed that they were making a low-risk investment. The company had been around for decades and paid a solid dividend, which it increased every year. It had a large branch network and billions in deposits. However, during the 2000s, Washington Mutual was also making increasingly risky mortgage loans, reportedly giving mortgages to people without properly verifying if they had the funds to pay back those loans on time. By 2008, many borrowers were beginning to default on their loans, and Washington Mutual had to take multibillion-dollar write-downs on the value of its loan portfolio, effectively destroying its once-strong balance sheet. The losses were so large that customers with deposits at the bank started to worry about its stability, and they withdrew nearly \$16 billion in November 2008 from accounts at Washington Mutual. The stock price collapsed from around \$40 at the start of 2008 to under \$2 a share, and with the bank teetering on the brink of collapse, the federal government intervened, seized the bank's assets, and engineered a sale to J.P. Morgan. Washington Mutual's shareholders got absolutely nothing: They were wiped out.

Over the past decade, maximizing returns to stockholders has taken on significant importance as an increasing number of employees have become stockholders in the companies for which they work through employee stock ownership plans (ESOPs). At Wal-Mart, for example, all employees who have worked for more than 1 year are

risk capital

Capital that cannot be recovered if a company fails and goes bankrupt.

eligible for the company's ESOP. Under an ESOP, employees are given the opportunity to purchase stock in the company, sometimes at a discount or less than the market value of the stock. The company may also contribute a certain portion of the purchase price to the ESOP. By making employees stockholders, ESOPs tend to increase the already strong emphasis on maximizing returns to stockholders, for they now help to satisfy two key stakeholder groups: stockholders and employees.

11-2c Profitability, Profit Growth, and Stakeholder Claims

Because of the unique position assigned to stockholders, managers normally seek to pursue strategies that maximize the returns that stockholders receive from holding shares in the company. As we noted in Chapter 1, stockholders receive a return on their investment in a company's stock in two ways: from dividend payments and from capital appreciation in the market value of a share (that is, by increases in stock market prices). The best way for managers to generate the funds for future dividend payments and keep the stock price appreciating is to pursue strategies that maximize the company's long-term profitability (as measured by the return on invested capital, ROIC) and grow the profits of the company over time.¹⁸

As we saw in Chapter 3, ROIC is an excellent measure of the profitability of a company. It tells managers how efficiently they are using the capital resources of the company (including the risk capital provided by stockholders) to generate profits. A company that is generating a positive ROIC is covering all of its ongoing expenses and has money left over, which is then added to shareholders' equity, thereby increasing the value of a company and thus the value of a share of stock in the company. The value of each share will increase further if a company can grow its profits over time, because then the profit that is attributable to every share (that is, the company's earnings per share) will also grow. As we have seen in this book, to grow profits, companies must do one or more of the following: (a) increase the margins earned on their products and services, (b) maintain margins and share while participating in a market that is growing, (c) maintain margins while taking market share from competitors, or (d) develop new markets through innovation, geographic expansion, or diversification.

Although managers should strive for profit growth if they are trying to maximize shareholder value, the relationship between profitability and profit growth is a complex one because attaining future profit growth may require investments that reduce the current rate of profitability. The task of managers is to find the right balance between profitability and profit growth.¹⁹ Too much emphasis on current profitability at the expense of future profitability and profit growth can make an enterprise less attractive to shareholders. Too much emphasis on profit growth can reduce the current profitability of the enterprise and have the same effect. In an uncertain world where the future is unknowable, finding the right balance between profitability and profit growth is as much art as it is science, but it is something that managers must try to do.

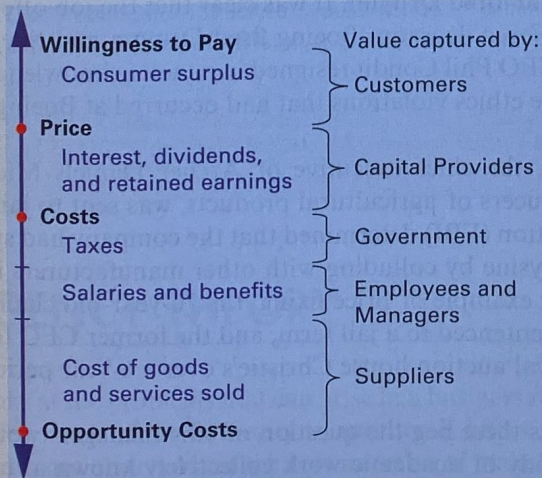
In addition to maximizing returns to stockholders, boosting a company's profitability and profit growth rate is consistent with satisfying the claims of several other key stakeholder groups. When a company is profitable and its profits continue to grow, it can pay higher salaries to productive employees and afford benefits such as health insurance coverage, all of which help to satisfy employees. In addition, companies with a high level of profitability and profit growth have no problem meeting their debt commitments, which provides creditors, including bondholders, with a measure of security. Profitable organizations are also better able to undertake philanthropic investments, which can help to satisfy some of the claims that local communities and the public place on a

company. Pursuing strategies that maximize long-term profitability and profit growth is therefore generally consistent with satisfying the claims of various stakeholder groups.

Stakeholder management requires consideration of how the firm's practices affect the cooperation of stakeholders in the short term, the benefits of building trust and a knowledge-sharing culture with stakeholders in the long run, and the firm's profitability and growth that **will** enable it to serve stakeholder interests in the future.²⁰ The company that overpays its employees in the current period, for example, may have very happy employees for a short while, but such action will raise the company's cost structure and limit its ability to attain a competitive advantage in the marketplace, thereby depressing its long-term profitability and hurting its ability to award future pay increases. As far as employees are concerned, the way many companies deal with this situation is to make future pay raises contingent upon improvements in labor productivity. If labor productivity increases, labor costs as a percentage of revenues will fall, profitability will rise, and the company can afford to pay its employees more and offer greater benefits.

Of course, not all stakeholder groups want the company to maximize its long-run profitability and profit growth. Suppliers are more comfortable about selling goods and services to profitable companies because they can be assured that the company will have the funds to pay for those products. Similarly, customers may be more willing to purchase from profitable companies because they can be assured that those companies will be around in the long term to provide after-sales services and support. But neither suppliers nor customers want the company to maximize its profitability at their expense. Rather, they would like to capture some of these profits from the company in the form of higher prices for their goods and services (in the case of suppliers), or lower prices for the products they purchase from the company (in the case of customers). Garcia-Castro and Aguilera capture this dynamic nicely by breaking the traditional explanation of value creation and value capture (discussed in Chapter 3) down into more fine-grained categories that show how value is created and captured by multiple stakeholders, similar to Figure 11.2.²¹

Figure 11.2 Value Creation and Capture with Multiple Stakeholder Groups



Source: Adapted from R. Garcia-Castro and R. Aguilera, "Increasing Value Creation and Appropriation in a World with Multiple Stakeholders," *Strategic Management Journal*, 36 (2015): 137–147.

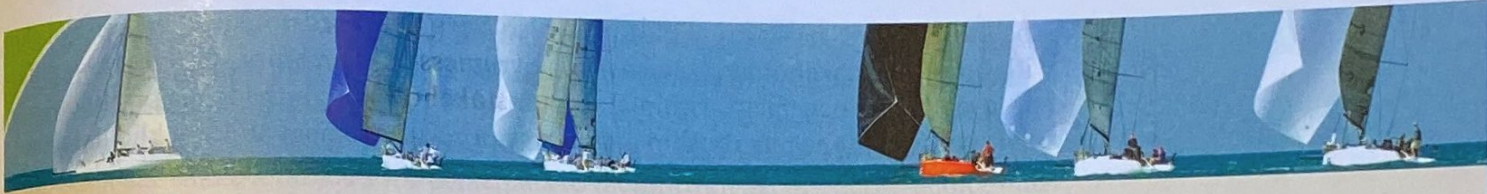
As shown, the total value that is created is the spread between the opportunity costs of the resources it employs and the willingness-to-pay of its customers. However, value is created and captured by different stakeholders. Suppliers create and capture value in the form of goods and services they sell to the firm; employees and management create value through their labor and capture value in the form of salaries and other benefits; government creates value in the form of providing the broad infrastructure in which the firm operates and captures value in the form of taxes; debt providers and stockholders create value by providing capital to the firm that it can use to finance its operations, and they capture value in the form of interest, dividends, and capital gains. Finally, customers capture value in the form of consumer surplus—the difference between the price they pay for goods and their true willingness-to-pay.

Despite the argument that maximizing long-term profitability and profit growth is the best way to satisfy the claims of several key stakeholder groups, it should be noted that a company must do so within the limits set by the law and in a manner consistent with societal expectations. The unfettered pursuit of profit can lead to behaviors that are outlawed by government regulations, opposed by important public constituencies, or simply unethical. Governments have enacted a wide range of regulations to govern business behavior, including antitrust laws, environmental laws, and laws pertaining to health and safety in the workplace. It is incumbent on managers to make sure that the company is in compliance with these laws when pursuing strategies.

Unfortunately, there is plenty of evidence that managers can be tempted to cross the line between legal and illegal in their pursuit of greater profitability and profit growth. For example, in mid-2003, the U.S. Air Force stripped Boeing of \$1 billion in contracts to launch satellites when it was discovered that Boeing had obtained thousands of pages of proprietary information from rival Lockheed Martin. Boeing had used that information to prepare its winning bid for the satellite contract. This was followed by the revelation that Boeing's CFO, Mike Sears, had offered a government official, Darleen Druyun, a lucrative job at Boeing while Druyun was still involved in evaluating whether Boeing should be awarded a \$17-billion contract to build tankers for the Air Force. Boeing won the contract against strong competition from Airbus, and hired Druyun. It was clear that the job offer may have had an impact on the Air Force decision. Boeing fired Druyun and the CFO, and shortly thereafter, Boeing CEO Phil Condit resigned in a tacit acknowledgment that he bore responsibility for the ethics violations that had occurred at Boeing during his tenure as leader.²²

In another case, the chief executive of Archer Daniels Midland, one of the world's largest producers of agricultural products, was sent to jail after the Federal Bureau of Investigation (FBI) determined that the company had systematically tried to fix the price for lysine by colluding with other manufacturers in the global marketplace. In another example of price fixing, the 76-year-old chairman of Sotheby's auction house was sentenced to a jail term, and the former CEO to house arrest, for fixing prices with rival auction house Christie's over a 6-year period (see Strategy in Action 11.1).

Examples such as these beg the question of why managers would engage in such risky behavior. A body of academic work collectively known as agency theory provides an explanation for why managers might engage in behavior that is either illegal or, at the very least, not in the interest of the company's shareholders.



11.1 STRATEGY IN ACTION

Price Fixing at Sotheby's and Christie's

Sotheby's and Christie's are the two largest fine-art auction houses in the world. In the mid-1990s, the two companies controlled 90% of the fine-art auction market, which at the time was worth approximately \$4 billion annually. Traditionally, auction houses earn their profits by the commissions they charge on auction sales. In good times, these commissions can be as high as 10% on some items, but in the early 1990s, the auction business was in a slump, with the supply of art for auction shriveling. With Sotheby's and Christie's desperate for works of art, sellers played the two houses against each other, driving commissions down to 2%, or sometimes lower.

To try to control this situation, Sotheby CEO Dede Brooks, met with Christie CEO Christopher Davidge in a series of clandestine meetings held in parking lots that began in 1993. Brooks claimed that she was acting on behalf of her boss, Alfred Taubman, the chairman and controlling shareholder of Sotheby's. According to Brooks, Taubman had agreed with the chairman of Christie's, Anthony Tennant, to work together in the weak auction market and limit price competition. In their meetings, Brooks and Davidge agreed to a fixed and nonnegotiable commission structure. Based on a sliding scale, the commission structure would range from 10% on a \$100,000 item to 2% on a \$5-million

item. In effect, Brooks and Davidge were agreeing to eliminate price competition between them, thereby guaranteeing both auction houses higher profits. The price-fixing agreement began in 1993 and continued unabated for 6 years, until federal investigators uncovered the arrangement and brought charges against Sotheby's and Christie's.

With the deal out in the open, lawyers filed several class-action lawsuits on behalf of the sellers that had been defrauded. Ultimately, at least 100,000 sellers signed on to the class-action lawsuits, which the auction houses settled with a \$512-million payment. The auction houses also pleaded guilty to price fixing and paid \$45 million in fines to U.S. antitrust authorities. As for the key players, the chairman of Christie's, as a British subject, was able to avoid prosecution in the United States (price fixing is not an offense for which someone can be extradited). Davidge struck a deal with prosecutors, and in return for amnesty turned over incriminating documents to the authorities. Brooks also cooperated with federal prosecutors and avoided jail (in April 2002, she was sentenced to 3 years of probation, 6 months of home detention, 1,000 hours of community service, and a \$350,000 fine). Taubman, ultimately isolated by all his former coconspirators, was sentenced to 1 year in jail and fined \$7.5 million.

Sources: S. Tully, "A House Divided," *Fortune*, December 18, 2000, pp. 264–275; J. Chaffin, "Sotheby's Ex CEO Spared Jail Sentence," *Financial Times*, April 30, 2002, p. 10; T. Thorncroft, "A Courtroom Battle of the Vanities," *Financial Times*, November 3, 2001, p. 3.

11-3 AGENCY THEORY

Agency theory looks at the problems that can arise in a business relationship when one person delegates decision-making authority to another. It offers a way of understanding why managers do not always act in the best interests of stakeholders and why they might sometimes behave unethically, and, perhaps, also illegally.²³ Although agency theory was originally formulated to capture the relationship between management and

stockholders, the basic principles have also been extended to cover the relationship with other key stakeholders, such as employees, as well as relationships between different layers of management within a corporation.²⁴ Although the focus of attention in this section is on the relationship between senior management and stockholders, some of the same language can be applied to the relationship between other stakeholders and top managers, and between top management and lower levels of management.

11-3a Principal-Agent Relationships

The basic propositions of agency theory are relatively straightforward. First, an agency relationship is held to arise whenever one party delegates decision-making authority or control over resources to another. The principal is the person delegating authority, and the agent is the person to whom authority is delegated. The relationship between stockholders and senior managers is the classic example of an agency relationship. Stockholders, who are the principals, provide the company with risk capital but delegate control over that capital to senior managers, and particularly to the CEO, who, as their agent, is expected to use that capital in a manner consistent with the best interests of stockholders. As we have seen, this means using capital to maximize the company's long-term profitability and profit growth rate.

The agency relationship continues down the hierarchy within the company. For example, in a large, complex, multibusiness company, top managers cannot possibly make all the important decisions; therefore, they delegate some decision-making authority and control over capital resources to business-unit (divisional) managers. Thus, just as senior managers such as the CEO are the agents of stockholders, business-unit managers are the agents of the CEO (and in this context, the CEO is the principal). The CEO entrusts business-unit managers to use the resources over which they have control in the most effective manner in order to maximize the performance of their units. This helps the CEO ensure that he or she maximizes the performance of the entire company, thereby discharging agency obligation to stockholders. More generally, whenever managers delegate authority to managers below them in the hierarchy and give them the right to control resources, an agency relation is established.

11-3b The Agency Problem

Although agency relationships often work well, problems may arise if agents and principals have different goals, and if agents take actions that are not in the best interests of their principals. Sometimes this occurs because an **information asymmetry** exists between the principal and the agent: Agents almost always have more information about the resources they are managing than principals do. Unscrupulous agents can take advantage of such information asymmetry to mislead principals and maximize their own interests at the expense of principals.

In the case of stockholders, the information asymmetry arises because they delegate decision-making authority to the CEO, their agent, who, by virtue of his or her position inside the company, is likely to know far more than stockholders do about the company's operations. Indeed, there may be certain information about the company that the CEO is unwilling to share with stockholders because that information would also help competitors. In such a case, withholding information from stockholders may be in the best interest of all. Generally, the CEO, involved in the day-to-day operations

information asymmetry

A situation where an agent has more information about the resources he or she is managing than the principal has.

of the company, is bound to have an information advantage over stockholders, just as the CEO's subordinates may have an information advantage over the CEO with regard to the resources under their control.²⁵

The information asymmetry between principals and agents is not necessarily a bad thing, but it can make it difficult for principals to measure an agent's performance and thus hold the agent accountable for how well he or she is using the entrusted resources. There is a certain amount of performance ambiguity inherent in the relationship between a principal and agent. Principals cannot know for sure if the agent is acting in his or her best interests. They cannot know for sure if the agent is using the resources to which he or she has been entrusted as effectively and efficiently as possible. This ambiguity is amplified by the fact that agents must engage in behavior that has outcomes for different time horizons. For example, investing in research and development may lower profits today but help to ensure the firm is profitable in the future. Principals who reward only immediate performance outcomes could induce myopic ("short-sighted") behavior on the part of the agent. To an extent, principals must trust the agent to do the right thing.

Of course, this trust is not blind: principals do put mechanisms in place with the purpose of monitoring agents, evaluating their performance, and, if necessary, taking corrective action. As we shall see shortly, the board of directors is one such mechanism, for, in part, the board exists to monitor and evaluate senior managers on behalf of stockholders. In Germany, the codetermination law (*Mitbestimmungsgesetz*) requires that firms with over 2,000 employees have boards of directors that represent the interests of employees—just under half of a firm's supervisory board members must represent workers. Other mechanisms serve a similar purpose. In the United States, publicly owned companies must regularly file detailed financial statements with the Securities and Exchange Commission (SEC) that are in accordance with generally agreed-upon accounting principles (GAAP). This requirement exists to give stockholders consistent, detailed information about how well management is using the capital with which it has been entrusted. Similarly, internal control systems within a company help the CEO ensure that subordinates are using the resources with which they have been entrusted to the best possible advantage.

Despite the existence of governance mechanisms and comprehensive measurement and control systems, a degree of information asymmetry will always remain between principals and agents, and there is always an element of trust involved in the relationship. Unfortunately, not all agents are worthy of this trust. A minority will deliberately mislead principals for personal gain, sometimes behaving unethically or breaking laws in the process, or engaging in behaviors that the principals would never condone.

The interests of principals and agents are not always the same; they diverge. For example, some authors argue that, like many other people, senior managers are motivated by desires for status, power, job security, and income.²⁵ By virtue of their position within the company, managers such as the CEO can use their authority and control over corporate funds to satisfy these desires at the cost of returns to stockholders. CEOs might use their position to invest corporate funds in various perks that enhance their status—executive jets, lavish offices, and expense-paid trips to exotic locales—rather than investing those funds in ways that increase stockholder returns. Economists have termed such behavior **on-the-job consumption**.²⁶

Aside from engaging in on-the-job consumption, CEOs, along with other senior managers, might satisfy their desire for greater income by using their influence or control over the board of directors to persuade the compensation committee of the

on-the-job consumption

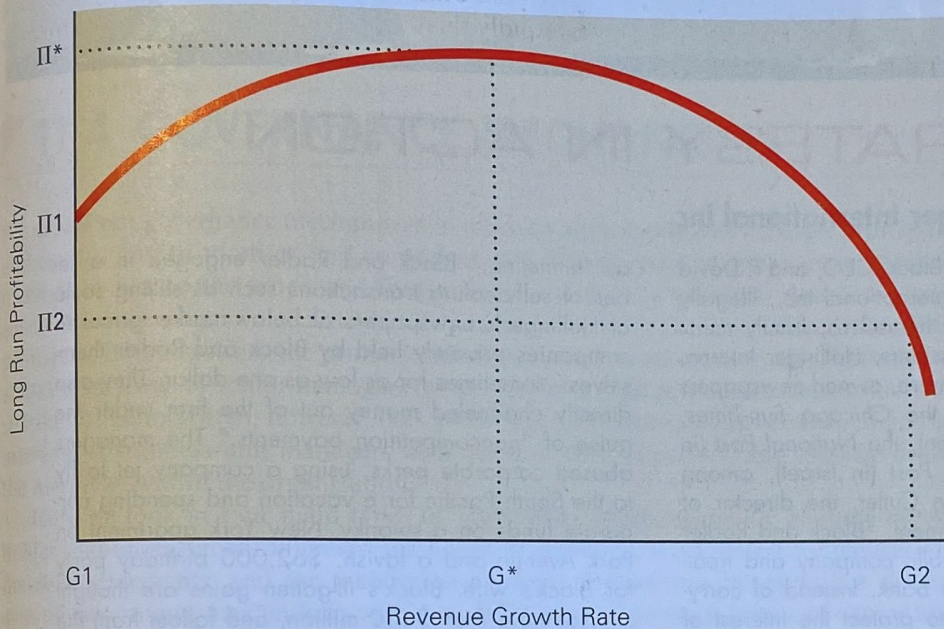
A term used by economists to describe the behavior of senior management's use of company funds to acquire perks (lavish offices, jets, and the like) that will enhance their status, instead of investing the funds to increase stockholder returns.

board to grant pay increases. Critics of U.S. industry claim that extraordinary pay has now become an endemic problem, and that senior managers are enriching themselves at the expense of stockholders and other employees. They point out that CEO pay has been increasing far more rapidly than the pay of average workers, primarily because of very liberal stock option grants that enable a CEO to earn huge pay bonuses in a rising stock market, even if the company underperforms the market and competitors.²⁷ In 1980, the average CEO in *Business Week's* survey of CEOs of the largest 500 American companies earned 42 times what the average blue-collar worker earned. By 1990, this figure had increased to 85 times. In 2013, the AFL-CIO's Executive PayWatch database reported that American CEOs made 331 times the pay of average workers.²⁸

The size of some CEO pay packages, and their apparent lack of relationship to company performance, rankles critics.²⁹ In 2010, a study by Graef Crystal evaluating the relationship between CEO pay and performance concluded that there virtually is none. For example, if CEOs were paid according to shareholder return, the CEO of CBS Corporation, Leslie Moonves, who earned an impressive \$43.2 million in 2009, should have gotten a \$28 million pay cut, according to Crystal.³⁰ Critics argue that CEO compensation is disproportionate to achievement, representing a clear example of the agency problem. However, in response to shareholder pressure, in recent years more companies have begun adopting compensation practices that more closely tie CEO pay to performance. For example, at Air Products & Chemicals, when the earnings per share fell short of its 9% growth target in 2012, CEO John McGlade paid the price in the form of a 65% cut in his annual bonus. His stock grants and stock options decreased as well, reducing his total direct compensation 19%, to 9.1 million.³¹

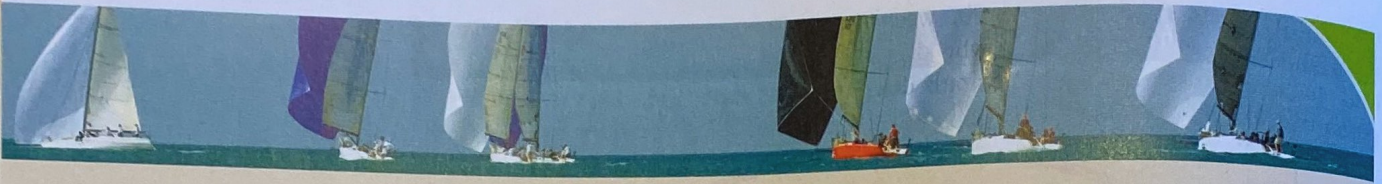
A further concern is that in trying to satisfy a desire for status, security, power, and income, a CEO might engage in empire building—buying many new businesses in an attempt to increase the size of the company through diversification.³² Although such growth may depress the company's long-term profitability and thus stockholder returns, it increases the size of the empire under the CEO's control and, by extension, the CEO's status, power, security, and income (there is a strong relationship between company size and CEO pay). Instead of trying to maximize stockholder returns by seeking the right balance between profitability and profit growth, some senior managers may trade long-term profitability for greater company growth via new business purchases. For example, in the mid-1970s, Compagnie Générale des Eaux was primarily a water utility and waste-management company, operating “near-monopolies” in local municipalities in France and generating strong, stable cash flows for its shareholders. However, a series of audacious, debt-funded acquisitions in the 1980s and 1990s, first by CEO Guy DeJouany and later by his successor, Jean-Marie Messier, rapidly transformed the company into one of the world's largest media and telecom empires, renamed Vivendi.” Then, in the 2000s, as the tech, media, and telecom bubble burst, the Vivendi empire came crashing down under the weight of its debt burden. Jean-Marie Messier was investigated by both French and U.S. courts, and was accused of misleading shareholders, misappropriating funds, and worsening the company's precarious position. He was fined and forced to resign.³³

Figure 11.3 graphs long-term profitability against the rate of growth in company revenues. A company that does not grow is likely missing out on profitable opportunities.³⁴ A moderate revenue growth rate of G^* allows a company to maximize long-term

Figure 11.3 The Trade-off Between Profitability and Revenue Growth Rates

profitability, generating a return of π^* . Thus, a growth rate of G_1 in Figure 11.3 is not consistent with maximizing profitability ($\pi_1 < \pi^*$). By the same token, however, attaining growth in excess of G_2 requires moving into market segments that earn lower profit margins or diversification into areas that the company knows little about. Consequently, it can be achieved only by sacrificing profitability; that is, past G^* , the investment required to finance further growth does not produce an adequate return, and the company's profitability declines. Yet G_2 may be the growth rate favored by an empire-building CEO, for it will increase his or her power, status, and income. At this growth rate, profitability is equal only to π_2 . Because $\pi^* < \pi_2$, a company growing at this rate is clearly not maximizing its long-run profitability or the wealth of its stockholders.

The magnitude of agency problems was emphasized in the early 2000s, when a series of scandals swept through the corporate world, many of which could be attributed to self-interest-seeking senior executives and a failure of corporate governance mechanisms. In 2003, an investigation revealed that Hollinger CEO Conrad Black, had used "tunneling" to divert over \$400 million in company funds to his family and friends (see the Strategy in Action 11.2 for more details on Hollinger and Black). Between 2001 and 2004, accounting scandals unfolded at a number of major corporations, including Enron, WorldCom, Tyco, Computer Associates, HealthSouth, Adelphia Communications, Dynegy, Royal Dutch Shell, and Parmalat, a major Italian food company. At Enron, \$27 billion in debt was hidden from shareholders, employees, and regulators in special partnerships that were removed from the balance sheet. At Parmalat, managers apparently "invented" \$8 to \$12 billion in assets to shore up the company's balance sheet—assets that never existed. In the case of Royal Dutch Shell, senior managers knowingly



11.2 STRATEGY IN ACTION

Self-Dealing at Hollinger International Inc.

From 1999 to 2003, Conrad Black, CEO, and F. David Radler, COO, of Hollinger International Inc., illegally diverted cash and assets to themselves, family members, and other corporate insiders. Hollinger International, a global publishing empire, owned newspapers around the world, such as the *Chicago Sun-Times*, the *Daily Telegraph* (in London), the *National Post* (in Toronto), and the *Jerusalem Post* (in Israel), among others. According to Stephen Cutler, the director of the SEC's Division of Enforcement, "Black and Radler abused their control of a public company and treated it as their personal piggy bank. Instead of carrying out their responsibilities to protect the interest of public shareholders, the defendants cheated and defrauded these shareholders through a series of deceptive schemes and misstatements." In a practice known

as "tunneling," Black and Radler engaged in a series of self-dealing transactions such as selling some of Hollinger's newspapers at below-market prices to companies privately held by Black and Radler themselves—sometimes for as low as one dollar. They also directly channeled money out of the firm under the guise of "noncompetition payments." The managers abused corporate perks, using a company jet to fly to the South Pacific for a vacation and spending corporate funds on a swanky, New York apartment on Park Avenue and a lavish, \$62,000 birthday party for Black's wife. Black's ill-gotten gains are thought to total more than \$400 million, and fallout from the scandal resulted in a loss of \$2 billion in shareholder value. Although Black was sentenced to 6½ years in jail, he ultimately only served 42 months.

Sources: S. Taub, "SEC Charges Hollinger, Two Executives," *CFO*, November 16, 2004; www.cfo.com, U.S. Department of Justice, "Former Hollinger Chairman Conrad Black and Three Other Executives Indicted in U.S.-Canada Corporate Fraud Schemes," indictment released November 17, 2005; "Ex-Media Mogul Black Convicted of Fraud," *Associated Press*, July 13, 2007; A. Stern, "Ex-Media Mogul Conrad Black Sent Back to Prison," *Reuters*, June 24, 2011.

inflated the value of the company's oil reserves by one-fifth, which amounted to 4 billion barrels of oil that never existed, making the company appear much more valuable than it was. At the other companies, earnings were systematically overstated, often by hundreds of millions of dollars, or even billions of dollars in the case of Tyco and WorldCom, which understated its expenses by \$3 billion in 2001. In all of these cases, the prime motivation seems to have been an effort to present a more favorable view of corporate affairs to shareholders than was the case, thereby securing senior executives significantly higher pay packets.³⁵

It is important to remember that the agency problem is not confined to the relationship between senior managers and stockholders. It can also bedevil the relationship between the CEO and subordinates, and between them and their subordinates. Subordinates might use control over information to distort the true performance of their unit in order to enhance their pay, increase their job security, or make sure their unit gets more than its fair share of company resources.

Confronted with agency problems, the challenge for principals is to (1) shape the behavior of agents so that they act in accordance with the goals set by principals,

(2) reduce information asymmetry between agents and principals, and (3) develop mechanisms for removing agents who do not act in accordance with the goals of principals and mislead them. Principals deal with these challenges through a series of governance mechanisms.

11-4 GOVERNANCE MECHANISMS

Principals put governance mechanisms in place to align incentives between principals and agents, and to monitor and control agents. The purpose of governance mechanisms is to reduce the scope and frequency of the agency problem; that is, to help ensure that agents act in a manner that is consistent with the best interests of their principals. In this section, the primary focus is on governance mechanisms that exist to align the interests of senior managers (as agents) with their principals, stockholders. It should not be forgotten, however, that governance mechanisms also exist to align the interests of business-unit managers with those of their superiors, and likewise down the hierarchy within the organization.

Here we look at four main types of governance mechanisms for aligning stockholder and management interests: the board of directors, stock-based compensation, financial statements, and the takeover constraint. The section closes with a discussion of governance mechanisms within a company to align the interests of senior and lower-level managers.

11-4a The Board of Directors

The board of directors is the centerpiece of the corporate governance system. Board members are directly elected by stockholders, and under corporate law they represent the stockholders' interests in the company. Hence, the board can be held legally accountable for the company's actions. Its position at the apex of decision making within the company allows it to monitor corporate strategy decisions and ensure that they are consistent with stockholder interests. If the board believes that corporate strategies are not in the best interest of stockholders, it can take measures such as voting against management nominations to the board of directors, or submitting its own nominees. In addition, the board has the legal authority to hire, fire, and compensate corporate employees, including, most importantly, the CEO.³⁶ The board is also responsible for making sure that the company's audited financial statements present a true picture of its financial situation. Thus, the board exists to reduce the information asymmetry between stockholders and managers, and to monitor and control management actions on behalf of stockholders.

The typical board is composed of a mix of inside and outside directors. **Inside directors** are senior employees of the company, such as the CEO. They are required on the board because they have valuable information about the company's activities. Without such information, the board cannot adequately perform its monitoring function. But because insiders are full-time employees of the company, their interests tend to be aligned with those of management. Hence, outside directors are needed to bring objectivity to the monitoring and evaluation processes. **Outside directors** are not full-time employees of the company. Many of them are full-time, professional directors

inside directors

Senior employees of the company, such as the CEO.

outside directors

Directors who are not full-time employees of the company, needed to provide objectivity to the monitoring and evaluation of processes.

who hold positions on the boards of several companies. They need to maintain a reputation for competency, and so are motivated to perform their role as objectively and effectively as possible.³⁷

There is little doubt that many boards perform their assigned functions admirably. For example, when the board of Sotheby's discovered that the company had been engaged in price fixing with Christie's, board members moved quickly to oust both the CEO and the chairman of the company (see *Strategy in Action 11.1*). But not all boards perform as well as they should. The board of now-bankrupt energy company Enron approved the company's audited financial statements, which were later discovered to be grossly misleading.

Critics of the existing governance system charge that inside directors often dominate the outsiders on the board. Insiders can use their position within the management hierarchy to exercise control over the company-specific information that the board receives. Consequently, they can present information in a way that puts them in a favorable light. In addition, because insiders have intimate knowledge of the company's operations, and because superior knowledge and control over information are sources of power, they may be better positioned than outsiders to influence boardroom decision making. The board may become the captive of insiders and merely rubber-stamp management decisions instead of guarding stockholder interests.

Some observers contend that many boards are dominated by the company CEO, particularly when the CEO is also the chairman of the board.³⁸ To support this view, they point out that both inside and outside directors are often the CEO's nominees. The typical inside director is subordinate to the CEO in the company's hierarchy and therefore unlikely to criticize the boss. Nor can outside directors nominated by the CEO be expected to evaluate the CEO objectively. Sometimes CEOs sit on each other's boards as outside directors, forming "interlocking directorates" that may induce them to act in each other's interests. Thus, the loyalty of the board may be biased toward the CEO, not the stockholders. Moreover, a CEO who is also chairman of the board may be able to control the agenda of board discussions in such a manner as to deflect criticisms of his or her leadership. Notably, although shareholders ostensibly vote on board members, board members are not legally required to resign if they do not receive a majority of the vote. The Council of Institutional Investors (which represents pension funds, endowments, and other large investors) published a list of "zombie directors" in 2012—directors who were retained on boards despite being rejected by shareholders. The list involves a wide range of companies, from Boston Beer Company, to Loral Space and Communications, to Cablevision. In fact, Cablevision was listed as having three directors who lost their shareholder votes twice between 2010 and 2012, yet remained on the board.³⁹

In the aftermath of the wave of scandals that hit the corporate world in the early 2000s, there are clear signs that many corporate boards are moving away from merely rubber-stamping top-management decisions and are beginning to play a much more active role in corporate governance. In part, they have been prompted by new legislation such as the 2002 Sarbanes-Oxley Act in the United States, which tightened rules regulating corporate reporting and corporate governance. A growing trend on the part of the courts to hold directors liable for corporate misstatements has also been important. Powerful institutional investors such as pension funds have also been more aggressive in exerting their power, often pushing for more outside representation on the board of directors and for a separation between the roles of chairman and CEO. An apt example is provided by the settlement reached in September 2018 between

Tesla, Elon Musk, and the Securities Exchange Commission, requiring that Musk, who served in both the CEO and chairman of the board roles, would step down from his position as chairman. Musk had come under fire for tweeting that he intended to take the company private, and that funding was secured; the Securities and Exchange Commission believed the tweet was reckless and had the potential to mislead stockholders, and thus believed Musk needed more oversight.

In general, there has been growing pressure to have the chairman role go to an outsider rather than firm management. Partly as a result, more than 50% of firms on the Standard & Poor's 500 index split the chairman and CEO jobs as of December 2017—up from 25% 15 years earlier. However, only 28% of S&P 500 companies have an independent board chairman; chairmen of 21% of companies are former CEOs or current non-CEO executives.⁴⁰ Separating the role of chairman and CEO limits the ability of corporate insiders, particularly the CEO, to exercise control over the board. Regardless, it must be recognized that boards of directors do not work as well as they should in theory, and other mechanisms are needed to align the interests of stockholders and managers.

11-4b Stock-Based Compensation

According to agency theory, one of the best ways to reduce the scope of the agency problem is for principals to establish incentives for agents to behave in the company's best interest through pay-for-performance systems. In the case of stockholders and top managers, stockholders can encourage top managers to pursue strategies that maximize a company's long-term profitability and profit growth, and thus the gains from holding its stock, by linking the pay of those managers to the performance of the stock price.

Giving managers **stock options**—the right to purchase the company's shares at a predetermined (strike) price at some point in the future, usually within 10 years of the grant date—has been the most common pay-for-performance system. Typically, the strike price is the price at which the stock was trading when the option was originally granted. Ideally, stock options will motivate managers to adopt strategies that increase the share price of the company, for in doing so managers increase the value of their stock options. Granting managers stock if they attain predetermined performance targets is another stock-based, pay-for-performance system.

Several academic studies suggest that stock-based compensation schemes such as stock options and stock grants can align executive and stockholder interests. For instance, one study found that managers were more likely to consider the effects of their acquisition decisions on stockholder returns if they were significant shareholders.⁴¹ According to another study, managers who were significant stockholders were less likely to pursue strategies that would maximize the size of the company rather than its profitability.⁴² More generally, it is difficult to argue with the proposition that the chance to get rich from exercising stock options is the primary reason for the 14-hour days and 6-day workweeks that many employees of fast-growing companies experience.

However, the practice of granting stock options has become increasingly controversial. Many top managers earn huge bonuses from exercising stock options that were granted several years prior. Critics claim that these options are often too generous but do not deny that they motivate managers to improve company performance. A particular cause for concern is that stock options are often granted at such low strike prices

stock options

The right to purchase company stock at a predetermined price at some point in the future, usually within 10 years of the grant date.

that the CEO can hardly fail to make a significant amount of money by exercising them, even if the company underperforms in the stock market by a significant margin. A serious example of the agency problem emerged in 2005 and 2006, when the SEC investigated several companies that had granted stock options to senior executives and apparently “backdated” the stock to a time when the price was lower, enabling executives to earn more money than if those options had simply been dated on the day they were granted.⁴³ By late 2006, the SEC had investigated nearly 130 companies for possible fraud related to stock-option backdating, including such major corporations as Apple, Jabil Circuit, United Healthcare, and Home Depot.⁴⁴

Other critics of stock options, including the famous investor Warren Buffett, complain that huge stock-option grants increase the outstanding number of shares in a company and therefore dilute the equity of stockholders; accordingly, they should be shown in company accounts as an expense against profits. Under accounting regulations that were enforced until 2005, stock options, unlike wages and salaries, were not expensed. However, this has since changed, and as a result many companies are beginning to reduce their use of options. Microsoft, for example, which had long given generous stock-option grants to high-performing employees, replaced stock options with stock grants in 2005. Requiring senior management to hold large numbers of shares in the company also has its downside: Managers who hold a large portion of their personal wealth in the company they manage are likely to be underdiversified. This can lead to excessively risk-averse behavior, or overdiversification of the firm.

11-4c Financial Statements and Auditors

Publicly traded companies in the United States are required to file quarterly and annual reports with the SEC that are prepared according to GAAP. The purpose of this requirement is to give consistent, detailed, and accurate information about how efficiently and effectively the agents of stockholders—the managers—are running the company. To make sure that managers do not misrepresent financial information, the SEC also requires that the accounts be audited by an independent, accredited accounting firm. Similar regulations exist in most other developed nations. If the system works as intended, stockholders can have faith that the information contained in financial statements accurately reflects the state of affairs at a company. Among other things, such information can enable a stockholder to calculate the profitability (ROIC) of a company in which he or she invests and to compare its ROIC against that of competitors.

Unfortunately, this system has not always worked as intended in the United States. Despite the fact that the vast majority of companies do file accurate information in their financial statements, and although most auditors review that information accurately, there is substantial evidence that a minority of companies have abused the system, aided in part by the compliance of auditors. This was clearly an issue at bankrupt energy trader Enron, where the CFO and others misrepresented the true financial state of the company to investors by creating off-balance-sheet partnerships that hid the true state of Enron’s indebtedness from public view. Enron’s auditor, Arthur Andersen, was complicit with this deception and in direct violation of its fiduciary duty. Arthur Andersen had lucrative consulting contracts with Enron that it did not want to jeopardize by questioning the accuracy of the company’s financial statements. The losers in this mutual deception were shareholders, who relied completely upon inaccurate information to make their investment decisions.

There have been numerous examples in recent years of managers' gaming of financial statements to present a distorted picture of their company's finances to investors (see the accusations made by HP about Autonomy in the Closing Case, for example). The typical motive has been to inflate the earnings or revenues of a company, thereby generating investor enthusiasm and propelling the stock price higher, which gives managers an opportunity to cash in stock-option grants for huge personal gain, obviously at the expense of stockholders, who have been misled by the reports.

The gaming of financial statements by companies such as Enron raises serious questions about the accuracy of the information contained in audited financial statements. In response, Congress passed the Sarbanes-Oxley Act in 2002, representing the most far-reaching overhaul of accounting rules and corporate governance procedures since the 1930s. Among other things, Sarbanes-Oxley established an oversight board for accounting firms, required CEOs and CFOs to endorse their company's financial statements, and barred companies from hiring the same accounting firm for both auditing and consulting services.

11-4d The Takeover Constraint

Given the imperfections in corporate governance mechanisms, it is clear that the agency problem persists at some companies. However, stockholders do have residual power—they can always sell their shares. If stockholders sell in large numbers, the price of the company's shares will decline. If the share price falls far enough, the company might be worth less on the stock market than the actual value of its assets. At this point, the company may become an attractive acquisition target and runs the risk of being purchased by another enterprise, against the wishes of the target company's management.

The risk of being acquired by another company is known as the **takeover constraint**—it limits the extent to which managers can pursue strategies and take actions that put their own interests above those of stockholders. If they ignore stockholder interests and the company is acquired, senior managers typically lose their independence, and likely their jobs as well. Therefore, the threat of takeover can constrain management action and limit the worst excesses of the agency problem.

During the 1980s and early 1990s, the threat of takeover was often enforced by corporate raiders: individuals or corporations that purchase large blocks of shares in companies which appear to be pursuing strategies inconsistent with maximizing stockholder wealth. Corporate raiders argue that if these underperforming companies pursued different strategies, they could create more wealth for stockholders. Raiders purchase stock in a company either to take over the business and run it more efficiently, or to precipitate a change in top management, replacing the existing team with one more likely to maximize stockholder returns. Raiders are motivated not by altruism, but by gain. If they succeed in their takeover bid, they can institute strategies that create value for stockholders, including themselves. Even if a takeover bid fails, raiders can still earn millions, for their stockholdings will typically be bought out by the defending company for a hefty premium. Called **greenmail**, this source of gain has stirred much controversy and debate about its benefits. Whereas some claim that the threat posed by raiders has had a salutary effect on enterprise performance by pushing corporate management to run companies better, others counter that there is little evidence of this.⁴⁵

takeover constraint

The risk of being acquired by another company.

greenmail

A source of gaining wealth whereby corporate raiders either push companies to change their corporate strategy to one that will benefit stockholders, or charge a premium for stock when the company wants to buy it back.

Although the incidence of hostile takeover bids has fallen off significantly since the early 1990s, this should not imply that the takeover constraint has ceased to operate. Unique circumstances existed in the early 2000s that made it more difficult to execute hostile takeovers. The boom years of the 1990s left many corporations with excessive debt (corporate America entered the new century with record levels of debt on its balance sheets), limiting the ability to finance acquisitions, particularly hostile acquisitions, which are often particularly expensive. In addition, the market valuation of many companies became misaligned with underlying fundamentals during the stock market bubble of the 1990s, and after a substantial fall in certain segments of the stock market, such as the technology sector, present valuations are still high relative to historic norms—making the hostile acquisition of even poorly run and unprofitable companies expensive. However, takeovers tend to occur in cycles, and it seems likely that once excesses are worked out of the stock market and off corporate balance sheets, the takeover constraint will reassert itself. It should be remembered that the takeover constraint—the governance mechanism of last resort—is often invoked only when other governance mechanisms have failed.

11-4e Governance Mechanisms Inside a Company

Thus far, this chapter has focused on the governance mechanisms designed to reduce the agency problem that potentially exists between stockholders and managers. Agency relationships also exist within a company, and the agency problem can arise between levels of management. In this section, we explore how the agency problem can be reduced within a company by using two complementary governance mechanisms to align the incentives and behavior of employees with those of upper-level management: strategic control systems and incentive systems.

Strategic Control Systems Strategic control systems are the primary governance mechanisms established within a company to reduce the scope of the agency problem between levels of management. These systems are the formal, target-setting, measurement and feedback systems that allow managers to evaluate whether a company is executing the strategies necessary to maximize its long-term profitability and, in particular, whether the company is achieving superior efficiency, quality, innovation, and customer responsiveness. They are discussed in more detail in Chapter 12.

The purpose of strategic control systems is to (1) establish standards and targets against which performance can be measured, (2) create systems for measuring and monitoring performance on a regular basis, (3) compare actual performance against the established targets, and (4) evaluate results and take corrective action if necessary. In governance terms, their purpose is to ensure that lower-level managers, as the agents of top managers, act in a way that is consistent with top managers' goals—which should be to maximize the wealth of stockholders, subject to legal and ethical constraints.

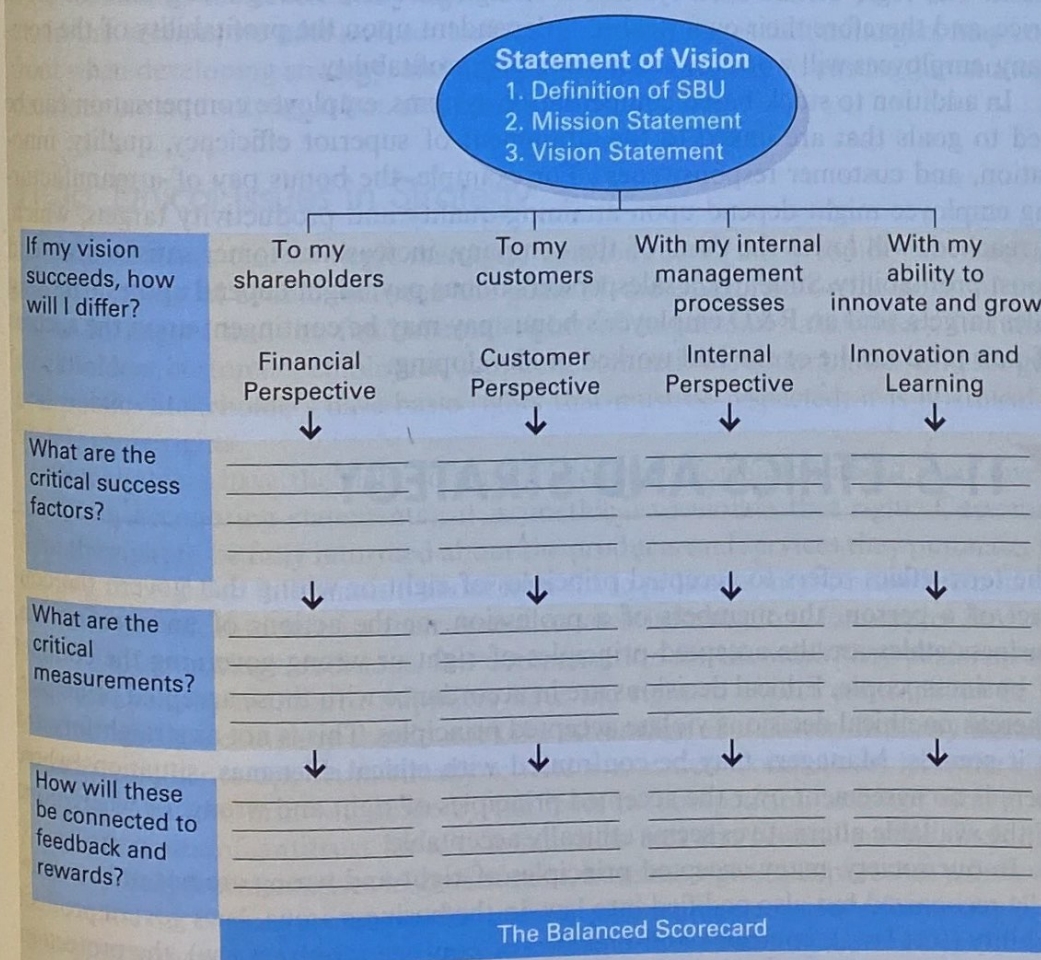
One increasingly influential model that guides managers through the process of creating the right kind of strategic control systems is the balanced scorecard model.⁴⁶ Managers have traditionally emphasized financial measures of performance such as ROIC to gauge and evaluate organizational performance. According to the balanced scorecard model financial information is extremely important, but it alone is not enough. If managers are to obtain a true picture of organizational performance, financial information must be supplemented with performance measures that indicate

how well an organization has been achieving the four building blocks of competitive advantage: efficiency, quality, innovation, and responsiveness to customers. This is because financial results simply inform managers about the results of strategic decisions they have already taken; the other measures balance this picture of performance by informing managers about how reliably the organization has in place the building blocks to drive future performance.⁴⁷

One version of the way the balanced scorecard operates is presented in Figure 11.4. Based on an organization's mission and goals, strategic managers develop a set of criteria for assessing performance according to multiple perspectives such as:

- *The financial perspective:* for example, ROIC, cash flow, and revenue growth
- *The customer perspective:* for example, satisfaction, product reliability, on-time delivery, and level of service
- *The internal perspective:* for example, efficiency, timeliness, and employee satisfaction
- *Innovation and learning:* for example, the number of new products introduced, the percentage of revenues generated from new products in a defined period, the time taken to develop the next generation of new products versus the competition, and the productivity of research and development (R&D)—how much R&D spending is required to produce a successful product

Figure 11.4 A Balanced Scorecard Approach



As Kaplan and Norton, the developers of this approach, suggest, "Think of the balanced scorecard as the dials and indicators in an airplane cockpit. For the complex task of navigating and flying an airplane, pilots need detailed information about many aspects of the flight. They need information on fuel, air speed, altitude, learning, destination, and other indicators that summarize the current and predicted environment. Reliance on one instrument can be fatal. Similarly, the complexity of managing an organization today requires that managers be able to view performance in several areas simultaneously."⁴⁸

Based on an evaluation of the complete set of measures in the balanced scorecard, strategic managers are in a good position to reevaluate the company's mission and goals and take corrective action to rectify problems, limit the agency problem, or exploit new opportunities by changing the organization's strategy and structure—which is the purpose of strategic control.

Employee Incentives Control systems alone may not be sufficient to align incentives between stockholders, senior management, and the organization as a whole. To help do this, positive incentive systems are often put into place to motivate employees to work toward goals that are central to maximizing long-term profitability. As already noted, ESOPs are one form of positive incentive, as are stock-option grants. In the 1990s, ESOPs and stock-ownership grants were pushed down deep within many organizations, meaning that employees at many levels of the firm were eligible for the plans. The logic behind such systems is straightforward: Recognizing that the stock price, and therefore their own wealth, is dependent upon the profitability of the company, employees will work toward maximizing profitability.

In addition to stock-based compensation systems, employee compensation can be tied to goals that are linked to the attainment of superior efficiency, quality, innovation, and customer responsiveness. For example, the bonus pay of a manufacturing employee might depend upon attaining quality and productivity targets, which, if reached, will lower the costs of the company, increase customer satisfaction, and boost profitability. Similarly, a salesperson's bonus pay might depend upon surpassing sales targets, and an R&D employee's bonus pay may be contingent upon the success of new products he or she had worked on developing.

ethics

Accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization.

business ethics

Accepted principles of right or wrong governing the conduct of businesspeople.

ethical dilemmas

Situations where there is no agreement over exactly what the accepted principles of right and wrong are, or where none of the available alternatives seems ethically acceptable.

11-5 ETHICS AND STRATEGY

The term **ethics** refers to accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization. **Business ethics** are the accepted principles of right or wrong governing the conduct of businesspeople. Ethical decisions are in accordance with those accepted principles, whereas unethical decisions violate accepted principles. This is not as straightforward as it sounds. Managers may be confronted with **ethical dilemmas**, situations where there is no agreement over the accepted principles of right and wrong, or where none of the available alternatives seems ethically acceptable.

In our society, many accepted principles of right and wrong are not only universally recognized but also codified into law. In the business arena, laws govern product liability (tort laws), contracts and breaches of contract (contract law), the protection of intellectual property (intellectual property law), competitive behavior (antitrust

law), and the selling of securities (securities law). Not only is it unethical to break these laws, it is illegal.

Unfortunately, as we have already seen in this chapter, managers do break laws. Moreover, managers may take advantage of ambiguities and gray areas in the law, of which there are many in our common law system, to pursue actions that are at best legally suspect and, in any event, clearly unethical. It is important to realize, however, that behaving ethically surpasses staying within the bounds of the law. The Opening Case shows that Volkswagen behaved both illegally and unethically in the “Dieselgate” scandal. In the Closing Case we show that Starbucks goes well beyond legal requirements to behave ethically by ensuring that its coffee is purchased from suppliers that use safe, fair, humane working and living conditions, including minimum-wage requirements and the prohibition of child and forced labor.

Many nations have different laws and ethical norms, making issues of ethics and legality vastly more complicated when firms’ activities span multiple national borders. Research by Surroca, Tribó, and Zahra on 110 multinational firms found that often multinational firms deal with stakeholder pressures and legal concerns in their home country by simply transferring their socially irresponsible practices to their overseas subsidiaries. The researchers found that this was particularly likely when it was not overtly apparent that the subsidiary had a connection to the multinational, suggesting that managers knew the behavior was unethical and did not want to be associated with it, yet continued the practice anyway.⁴⁹

In this section, we take a closer look at the ethical issues that managers may confront when developing strategy, and at the steps they can take to ensure that strategic decisions are not only legal but also ethical.

11-5a Ethical Issues in Strategy

The ethical issues that strategic managers confront cover many topics, but most are due to a potential conflict between the goals of the enterprise, or the goals of individual managers, and the fundamental rights of important stakeholders, including stockholders, customers, employees, suppliers, competitors, communities, and the general public. Stakeholders have basic rights that must be respected; it is unethical to violate those rights.

Stockholders have the right to timely, accurate information about their investments (in accounting statements); it is unethical to violate that right. Customers have the right to be fully informed about the products and services they purchase, including the right to information about how those products might cause them harm, and it is unethical to restrict their access to such information. Employees have the right to safe working conditions, fair compensation for the work they perform, and just treatment by managers. Suppliers have the right to expect contracts to be respected, and the company should not take advantage of a power disparity between it and a supplier to opportunistically rewrite a contract. Competitors have the right to expect that the firm will abide by the rules of competition and not violate the basic principles of antitrust laws. Communities and the general public, including their political representatives in government, have the right to expect that a firm will not violate the basic expectations that society places on enterprises—for example, by dumping toxic pollutants into the environment, or overcharging for work performed on government contracts.

Those who take the stakeholder view of business ethics often argue that it is in the enlightened self-interest of managers to behave in an ethical manner that recognizes and respects the fundamental rights of stakeholders, because doing so will ensure the support of stakeholders and, ultimately, benefit the firm and its managers. Others go beyond this instrumental approach to ethics and argue that, in many cases, acting ethically is simply the right thing to do. They argue that businesses need to recognize their *noblesse oblige*—a French term that refers to honorable and benevolent behavior that is considered the responsibility of people of high (noble) birth—and give something back to the society that made their success possible. In a business setting, it is understood that benevolent behavior is the moral responsibility of successful enterprises.

Unethical behavior often arises in a corporate setting when managers decide to put the attainment of their own personal goals, or the goals of the enterprise, above the fundamental rights of one or more stakeholder groups (in other words, unethical behavior may arise from agency problems). The most common examples of such behavior involve self-dealing, information manipulation, anticompetitive behavior, opportunistic exploitation of other players in the value chain in which the firm is embedded (including suppliers, complement providers, and distributors), the maintenance of substandard working conditions, environmental degradation, and corruption.

self-dealing

Managers using company funds for their own personal consumption

information manipulation

When managers use their control over corporate data to distort or hide information in order to enhance their own financial situation or the competitive position of the firm.

anticompetitive behavior

A range of actions aimed at harming actual or potential competitors, most often by using monopoly power, and thereby enhancing the long-run prospects of the firm.

Self-dealing occurs when managers find a way to feather their own nests with corporate monies, as we have already discussed in several examples in this chapter (such as Conrad Black at Hollinger). **Information manipulation** occurs when managers use their control over corporate data to distort or hide information in order to enhance their own financial situation or the competitive position of the firm; HP accused Autonomy of this in the Closing Case. As we have seen, many accounting scandals have involved the deliberate manipulation of financial information. Information manipulation can also occur with nonfinancial data. An example is when managers at the tobacco companies suppressed internal research that linked smoking to health problems, violating the right of consumers to accurate information about the dangers of smoking. When this evidence came to light, lawyers filed class-action suits against the tobacco companies, claiming that they had intentionally caused harm to smokers—they had broken tort law by promoting a product that they knew was seriously harmful to consumers. In 1999, the tobacco companies settled a lawsuit brought by the states that sought to recover health-care costs associated with tobacco-related illnesses; the total payout to the states was \$260 billion.

Anticompetitive behavior covers a range of actions aimed at harming actual or potential competitors, most often by using monopoly power, and thereby enhancing the long-run prospects of the firm. For example, in the 1990s, the Justice Department claimed that Microsoft used its monopoly in operating systems to force PC makers to bundle Microsoft's Web browser, Internet Explorer, with the Windows operating system, and to display the Internet Explorer logo prominently on the computer desktop. Microsoft reportedly told PC makers that it would not supply them with Windows unless they did this. Because the PC makers needed Windows to sell their machines, this was a powerful threat. The alleged aim of the action, which exemplifies "tie-in sales"—which are illegal under antitrust laws—was to drive a competing browser maker, Netscape, out of business. The courts ruled that Microsoft was indeed abusing its monopoly power in this case and, under a 2001 consent decree, the company was forced to cease this practice.

Legality aside, the actions in which Microsoft managers allegedly engaged are unethical on at least three counts; first, by violating the rights of end-users by unfairly limiting their choice; second, by violating the rights of downstream participants in the industry value chain—in this case, PC makers—by forcing them to incorporate a particular product in their design; and third, by violating the rights of competitors to free and fair competition.

Opportunistic exploitation of other players in the value chain in which the firm is embedded is another example of unethical behavior. Exploitation of this kind typically occurs when the managers of a firm seek to unilaterally rewrite the terms of a contract with suppliers, buyers, or complement providers in a way that is more favorable to the firm, often using their power to force a revision to the contract. For example, in the late 1990s, Boeing entered into a \$2-billion contract with Titanium Metals Corporation to purchase certain amounts of titanium annually for 10 years. In 2000, after Titanium Metals had already spent \$100 million to expand its production capacity to fulfill the contract, Boeing demanded that the contract be renegotiated, asking for lower prices and an end to minimum-purchase agreements. As a major purchaser of titanium, managers at Boeing probably thought they had the power to push this contract revision through, and Titanium's investment meant that it would be unlikely that the company walk away from the deal. Titanium promptly sued Boeing for breach of contract. The dispute was settled out of court, and under a revised agreement Boeing agreed to pay monetary damages to Titanium Metals (reported to be in the \$60-million range) and entered into an amended contract to purchase titanium.⁵⁰ This action was arguably unethical because it violated the supplier's right to have a purchaser do business in a fair and open way, regardless of any issues of legality.

Substandard working conditions arise when managers underinvest in working conditions, or pay employees below-market rates, in order to reduce their production costs. The most extreme examples of such behavior occur when a firm establishes operations in countries that lack the workplace regulations found in developed nations such as the United States. For example, the Ohio Art Company ran into an ethical storm when newspaper reports alleged that it had moved production of its popular Etch A Sketch toy from Ohio to a supplier in Shenzhen Province, where employees—mostly teenagers—work long hours for \$0.24 per hour, below the legal minimum wage of \$0.33 per hour. Moreover, production reportedly started at 7:30 a.m. and continued until 10 p.m., with breaks only for lunch and dinner. Furthermore, Saturdays and Sundays were treated as normal workdays, meaning that employees worked 12 hours per day, 7 days per week, or 84 hours per week—well above the standard 40-hour week authorities set in Shenzhen. Working conditions such as these clearly violate employees' rights in China, as specified by local regulations (which are poorly enforced). Is it ethical for the Ohio Art Company to use such a supplier? Many would say it is not.⁵¹

Environmental degradation occurs when a company's actions directly or indirectly result in pollution or other forms of environmental harm. Environmental degradation can violate the right of local communities and the general public to clean air and water, land that is free from pollution by toxic chemicals, and properly managed forests.

Finally, **corruption** can arise in a business context when managers pay bribes to gain access to lucrative business contracts. For example, it was alleged that Halliburton was part of a consortium that paid nearly \$180 million in bribes to win a lucrative contract to build a natural gas plant in Nigeria.⁵² Similarly, between 2006 and 2009, Siemens was found guilty of paying hundreds of millions of dollars in bribes to secure sales contracts; the company was ultimately forced to pay hefty fines, and one

opportunistic exploitation

Unethical behavior sometimes used by managers to unilaterally rewrite the terms of a contract with suppliers, buyers, or complement providers in a way that favors to the firm.

substandard working conditions

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corruption

Can arise in a business context when managers pay bribes to gain access to lucrative business contracts.

Chinese executive who accepted \$5.1 million in bribes was sentenced to death by Chinese courts.⁵³ Corruption is clearly unethical because it violates many rights, including the right of competitors to a level playing field when bidding for contracts, and, when government officials are involved, the right of citizens to expect that government officials will act in the best interests of the local community (or nation), and not in response to corrupt payments.

11-5b The Roots of Unethical Behavior

Why do some managers behave unethically? What motivates managers to engage in actions that violate accepted principals of right and wrong, trample on the rights of one or more stakeholder groups, or simply break the law? Although there is no simple answer to this question, a few generalizations can be made.⁵⁴ First, it is important to recognize that business ethics are not divorced from **personal ethics**, which are the generally accepted principles of right and wrong governing the conduct of individuals. As individuals, we are taught that it is wrong to lie and cheat, and that it is right to behave with integrity and honor, and to stand up for what we believe to be true. The personal ethical code that guides behavior comes from many sources, including parents, schools, religion, and the media. A personal ethical code will exert a profound influence on the way an individual behaves as a businessperson. An individual with a strong sense of personal ethics is less likely to behave in an unethical manner in a business setting; in particular, he or she is less likely to engage in self-dealing and more likely to behave with integrity.

Second, many studies of unethical behavior in a business setting have come to the conclusion that businesspeople sometimes do not realize that they are behaving unethically, primarily because they simply fail to ask the relevant question: Is this decision or action ethical? Instead, they apply straightforward business calculus to what they perceive to be a business decision, forgetting that the decision may also have an important ethical dimension.⁵⁵ The fault here is within processes that do not incorporate ethical considerations into business decision making. This may have been the case at Nike and other textile companies when managers originally made subcontracting arrangements with contractors that operated factories as “sweatshops,” with long hours, low pay, and poor working conditions. Those decisions were probably based upon good economic logic. Subcontractors were probably chosen on the basis of business variables such as cost, delivery, and product quality, and key managers simply failed to ask: “How does this subcontractor treat its workforce?” If managers pondered this question at all, they probably reasoned that it was the subcontractor’s concern, not the company’s.

Unfortunately, the climate in some businesses does not encourage people to think through the ethical consequences of business decisions. This brings us to the third cause of unethical behavior in businesses: an organizational culture that de-emphasizes business ethics and considers all decisions to be purely economic ones. Individuals may believe their decisions within the workplace are not subject to the same ethical principles that govern their personal lives, or that their decisions within the firm do not really “belong” to them, but rather that they are merely acting as agents of the firm. A related fourth cause of unethical behavior may be pressure from top management to meet performance goals that are unrealistic and can only be attained by cutting corners or acting in an unethical manner. Thus, the pressure to perform induces

personal ethics

Generally accepted principles of right and wrong governing the conduct of individuals.

individuals to behave in ways they otherwise would not. This appears to have been the case at Volkswagen: Engineers were under extreme pressure to produce a diesel car that would be fuel efficient, powerful, and meet U.S. emission standards in order to meet then-CEO Winterkorn's goal of tripling U.S. sales. Documents from within the organization suggest that the company had a "culture of fear" that made employees so afraid of disappointing management they were willing to cheat even though they clearly knew it was both a legal and ethical violation.

An organizational culture can "legitimize" behavior that society would judge as unethical, particularly when this is mixed with a focus upon unrealistic performance goals such as maximizing short-term economic performance regardless of the costs. In such circumstances, there is a greater-than-average probability that managers will violate their own personal ethics and engage in behavior that is unethical. By the same token, an organization's culture can do just the opposite and reinforce the need for ethical behavior. Recreational Equipment Inc. (REI), for example, has a strong culture around valuing environmental sustainability, respect for individuals, and trustworthiness. The firm backs up this belief system with such policies as producing an annual environmental stewardship report and providing health-care benefits for all workers (including part-time employees), a retirement plan that does not require individual contributions, and grants for employees to contribute to their communities or to buy gear to pursue personal outdoor challenges. The company has made *Fortune's* "100 Best Companies to Work For" list every year since 1998.

This brings us to a fifth root cause of unethical behavior: *unethical leadership*. Leaders help to establish the culture of an organization, and they set the example that others follow. Other employees in a business often take their cues from business leaders, and if those leaders do not behave in an ethical manner, employees may not either. It is not what leaders say that matters, but what they do. A good example is Ken Lay, the former CEO of the failed energy company Enron. While constantly referring to Enron's code of ethics in public statements, Lay simultaneously engaged in behavior that was ethically suspect. Among other things, he failed to discipline subordinates who had inflated earnings by engaging in corrupt energy-trading schemes. Such behavior sent a very clear message to Enron's employees—unethical behavior would be tolerated if it could boost earnings.

11-5c Behaving Ethically

What is the best way for managers to ensure that ethical considerations are taken into account? In many cases, there is no easy answer to this question, for many of the most vexing ethical problems involve very real dilemmas and suggest no obvious right course of action. Nevertheless, managers can and should do at least seven things to ensure that basic ethical principles are adhered to, and that ethical issues are routinely considered when making business decisions. They can (1) favor hiring and promoting people with a well-grounded sense of personal ethics, (2) build an organizational culture that places a high value on ethical behavior, (3) make sure that leaders within the business not only articulate the rhetoric of ethical behavior but also act in a manner that is consistent with that rhetoric, (4) put decision-making processes in place that require people to consider the ethical dimension of business decisions, (5) use ethics officers, (6) put strong governance processes in place, and (7) act with moral courage.

Hiring and Promotion It seems obvious that businesses should strive to hire people who have a strong sense of personal ethics and would not engage in unethical or illegal behavior. Similarly, you would rightly expect a business to not promote people, and perhaps fire people, whose behavior does not match generally accepted ethical standards. But doing this is actually very difficult.

Is there anything that businesses can do to ensure they do not hire people who have poor personal ethics, particularly given that people have an incentive to hide this from public view (indeed, unethical people may well lie about their nature)? Businesses can give potential employees psychological tests to try to discern their ethical predisposition, and they can check with prior employees regarding someone's reputation, such as by asking for letters of reference and talking to people who have worked with the prospective employee. The latter approach is not uncommon and does influence the hiring process. Promoting people who have displayed poor ethics should not occur in an organization that values ethical behavior, and where leaders act accordingly.

code of ethics

Formal statement of the ethical priorities to which a business adheres.

Organization Culture and Leadership To foster ethical behavior, organizations must build an culture that places high value on ethical behavior. Three actions are particularly important. First, businesses must explicitly articulate values that place a strong emphasis on ethical behavior. Many companies now do this by drafting a **code of ethics**, a formal statement of the ethical priorities to which a business adheres—in fact, both the New York Stock Exchange and Nasdaq listing services require listed companies to have a code of ethics that identifies areas of ethical risk, provides guidance for recognizing and dealing with ethical issues, provides mechanisms for reporting unethical conduct, and notes procedures to ensure prompt action against violations.⁵⁶ Firms also sometimes incorporate ethical statements into documents that articulate the values or mission of the business. For example, the food and consumer products giant Unilever's code of ethics includes the following points: "We will not use any form of forced, compulsory or child labor" and "No employee may offer, give or receive any gift or payment which is, or may be construed as being, a bribe. Any demand for, or offer of, a bribe must be rejected immediately and reported to management."⁵⁷ Unilever's principles send a very clear message to managers and employees within the organization. Data from the National Business Ethics Survey, administered by the Ethics Resource Center, a U.S. nonprofit, has found that firms with strong, well-implemented ethics programs have significantly fewer cases of ethical misconduct.

Having articulated values in a code of ethics or some other document, it is important that business leaders give life and meaning to those words by repeatedly emphasizing their importance and then acting on them. This means using every relevant opportunity to stress the importance of business ethics and making sure that key business decisions not only make good economic sense but also are ethical. Many companies have gone a step further and hired independent firms to audit them and make sure that they are behaving in a manner consistent with their ethical codes. Nike, for example, has in recent years hired independent auditors to ensure that its subcontractors are adhering to Nike's code of conduct.

Finally, building an organization culture that places a high value on ethical behavior requires incentive and reward systems, including promotional systems that reward people who engage in ethical behavior and sanction those who do not.

Decision-Making Processes In addition to establishing the right kind of ethical culture in an organization, businesspeople must be able to think through the ethical implications of decisions in a systematic way. To do this, they need a moral compass, and beliefs about what determines individual rights and justice. Some experts on ethics have proposed a straightforward practical guide, or ethical algorithm, to determine whether a decision is ethical. A decision is acceptable on ethical grounds if a businessperson can answer “yes” to each of these questions:

1. Does my decision fall within the accepted values or standards that typically apply in the organizational environment (as articulated in a code of ethics or some other corporate statement)?
2. Am I willing to see the decision communicated to all stakeholders affected by it—for example, by having it reported in newspapers or on television?
3. Would the people with whom I have a significant personal relationship, such as family members, friends, or even managers in other businesses, approve of the decision?

Ethics Officers To make sure that a business behaves in an ethical manner, a number of firms now have ethics officers. These individuals are responsible for making sure that all employees are trained to be ethically aware; that ethical considerations enter the business decision-making process; and that employees adhere to the company's code of ethics. Ethics officers may also be responsible for auditing decisions to ensure that they are consistent with this code. In many businesses, ethics officers act as an internal ombudsperson with responsibility for handling confidential inquiries from employees, investigating complaints from employees or others, reporting findings, and making recommendations for change.

United Technologies, a large aerospace company with worldwide revenues of about \$60 billion, has had a formal code of ethics since 1990. There are now some 450 “business practice officers” (the company's name for ethics officers) within United Technologies who are responsible for making sure that employees adhere to the code. United Technologies also established an ombudsperson program in 1986 that allows employees to inquire anonymously about ethics issues.⁵⁸

Strong Corporate Governance Strong corporate governance procedures are needed to ensure that managers adhere to ethical norms—in particular, that senior managers do not engage in self-dealing or information manipulation. Strong corporate governance procedures require an independent board of directors that is willing to hold top managers accountable for self-dealing and can verify the information managers provide. If companies like Tyco, WorldCom, and Enron had had strong boards of directors, it is unlikely that they would have experienced accounting scandals, or that top managers would have been able to access the funds of these corporations as personal treasuries.

There are five cornerstones of strong governance. The first is a board of directors that is composed of a majority of outside directors who have no management responsibilities in the firm, are willing and able to hold top managers accountable, and have no business ties with important insiders. Outside directors should be individuals of high integrity whose reputation is based on their ability to act independently. The second cornerstone is a board where the positions of CEO and chairman are held by separate individuals and the chairman is an outside director.

When the CEO is also chairman of the board of directors, he or she can control the agenda, thereby furthering his or her own **personal agenda** (which may include self-dealing) or limiting criticism against current **corporate** policies. The third cornerstone is a compensation committee formed by the board that is composed entirely of outside directors. The compensation committee **sets** the level of pay for top managers, including stock-option grants and additional **benefits**. The scope of self-dealing is reduced by making sure that the compensation committee is independent of managers. Fourth, the audit committee of the board, **which** reviews the financial statements of the firm, should also be composed of outsiders, thereby encouraging vigorous, independent questioning of the firm's financial statements. Finally, the board should use outside auditors that are truly independent and do not have a conflict of interest. This was not the case in many recent accounting scandals, where outside auditors were also consultants to the corporation and therefore less likely to ask management hard questions for fear that doing so would jeopardize lucrative consulting contracts.

Moral Courage It is important to recognize that sometimes managers and others need significant moral courage. Moral courage enables managers to walk away from a decision that is profitable but unethical, gives employees the strength to say no to superiors who instruct them to behave unethically, and gives employees the integrity to contact the media and “blow the whistle” on persistent unethical behavior in a company. Moral courage does not come easily; there are well-known cases where individuals have lost their jobs because they were whistleblowers on unethical corporate behaviors.

Companies can strengthen the moral courage of employees by making a commitment to refuse to seek retribution against employees who exercise moral courage, say no to superiors, or otherwise complain about unethical actions. For example, Unilever's code of ethics includes the following:

Any breaches of the Code must be reported in accordance with the procedures specified by the Joint Secretaries. The Board of Unilever will not criticize management for any loss of business resulting from adherence to these principles and other mandatory policies and instructions. The Board of Unilever expects employees to bring to their attention, or to that of senior management, any breach or suspected breach of these principles. Provision has been made for employees to be able to report in confidence and no employee will suffer as a consequence of doing so.

This statement gives “permission” to employees to exercise moral courage. Companies can also set up an ethics hotline that allows employees to anonymously register a complaint with a corporate ethics officer.

Final Words The steps discussed here can help to ensure that when managers make business decisions, they are fully cognizant of the ethical implications and do not violate basic ethical prescripts. At the same time, not all ethical dilemmas have a clean and obvious solution—that is why they are dilemmas. At the end of the day, there are things that a business should not do, and there are things that a business should do, but there are also situations that present managers with true predicament. In these cases, a premium is placed upon the ability of managers to make sense out of complex, messy situations, and to make balanced decisions that are as just as possible.