CORPORATE GOVERNANCE AND ETHICS

AN ARISTOTELIAN PERSPECTIVE

Alejo José G. Sison

Foreword by Jeffrey Pfeffer

NEW HORIZONS IN LEADERSHIP STUDIES

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Alejo José G. Sison

University of Navarra, Spain

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Corporate Governance and Ethics

NEW HORIZONS IN LEADERSHIP STUDIES

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Professor and Coston Family Chair in Leadership and Ethics,
Jepson School of Leadership Studies, University of Richmond, USA

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Corporate Governance and Ethics
An Aristotelian Perspective
Alejo José G. Sison

For J.P. II, *i.m.*,
and J.E.R, P.O.D.

Foreword

There is little evidence that reforms in corporate governance have made any difference. The salaries of chief executives continue to soar in the U.S. and elsewhere as well, even though compensation committees must be independent and even though there is more disclosure of what people earn. Companies are still restating financial results at a prodigious rate and balance sheet and income statement surprises continue, even though accounting standards have presumably been tightened, audit fees have gone up, and CEOs must personally attest to the accuracy of the reports their companies release. And in the workplace, distrust of management and disengagement and diminished job satisfaction persist, resulting in ever higher levels of turnover and, as a result, lower levels of productivity and service – just fly on most airlines to see these facts at close range – even though most observers recognize a coming labour shortage and the importance of intellectual capital for business success in the modern economy.

For the most part, we have attacked the symptoms rather than the root cause of the problems. Reforms have been concerned with form instead of substance, with ensuring compliance instead of changing mindsets, with promulgating 'minimum standards' rather than with stimulating excellent and thoughtful leadership. The mindset that seems to dominate current discourse all over the world is one that emphasizes ends, achievements and objectives, and plays down the means and processes employed in their attainment. In business and in society more generally, we do not look too hard at the price paid for 'success'. Robert Reich's new book on *Supercapitalism* argues that, even as we achieved lower prices through globalization and deregulation, we have diminished citizenship and impoverished community and social life. Dennis Bakke, co-founder of the large independent power producer, AES, has argued that there are things we should do in creating our workplaces not to make them more efficient or effective, but simply because to do otherwise is inconsistent with the values we should hold for locales that can either diminish or uplift the human spirit.

Alejo Sison believes that we ought to elevate the consideration of our 'philosophy' of management and governance to centre stage. As part of that elevation, we need to educate people in leadership roles to be as expert in thinking about purpose, values and the philosophical underpinnings of their choices as they are in the more technical aspects of management such as understanding financial statements and probability. And as part of the role of philosophy, we should subject organizations and their leaders to scrutiny – not just through the lens of compliance and law, but also through the great moral ideas that form the basis of philosophical discourse and analysis.

This is an argument and an analysis that must be true. To move beyond the obsession with results that has resulted in environmental degradation, enormous increases in income inequality and, in many countries, outright corruption in the service of getting deals done, management needs to reconnect with its fundamental moral purposes. Rakesh Khurana's recent book, *From Higher Aims to Hired Hands*, provides an historical account of how management education has lost its way. This book by Sison provides a way forward to rethink what companies are about, how they are to be governed, and what it means to be a leader in an organizational world where people's financial, physical and mental well-being are inextricably tied to what happens to them in organizations. *Why* we do what we do is as important as *what* we do. Understanding why entails revisiting questions that have occupied philosophy over the ages. There is no more important task in today's world.

Jeffrey Pfeffer
Thomas D. Dee II Professor of Organizational Behavior
Graduate School of Business
Stanford University

Introduction and acknowledgements

I suppose that most people write to convey information and knowledge they already possess. I write primarily to begin to learn about something that interests me; as part of an effort to try to make sense of matters which everyone else may be talking about, but – to my mind – rather aimlessly and without reaching any robust conclusions. This was how I started my research on corporate governance. (To what extent I still am very much of a novice or learner in the field, even after finishing this book, I leave to the kindly reader to respond.) Once more, to guide me in my inquiry, I chose Aristotle, particularly his treatise on *The Politics*. In the same way that my previous work, *The Moral Capital of Leaders. Why Virtue Matters* could be considered a reading of Aristotle's *Nicomachean Ethics* addressed to a business audience, this present volume may be taken as a digest of *The Politics* for members of corporate boards and directors of organizations.

The first two chapters identify my point of departure, that is, the dominant, commonplace understanding both of the firm – a 'money-making machine' – and of corporate governance – compliance by 'box-ticking'. I challenge this peacefully accepted and widespread notion of the firm by presenting a case that serves as a counterexample: *Tasubinsa* certainly seeks profits, but only in a manner subservient to its main goal, the complete social integration of the mentally handicapped who constitute more than 90 per cent of its workforce. To be sure, this single case would not be enough to topple the prevalent and long-established model, yet, at the very least, it could still raise serious doubts while opening up space for the development of a new theory of the firm. Any business organization should exist, above all, in order to contribute to the common good of society. Rather than as a machine, a company should be thought of as a community of workers who seek their own integral human development by producing the goods and services that society needs. Profits should be regarded as a supervenient prize for a job well done, not something to be gained at all costs, regardless of the means. As for the box-ticking corporate governance model that Sarbanes–Oxley has set, perhaps the strongest argument against it lies in the fact that Enron itself could have been essentially a Sarbanes–Oxley-compliant company. Conformity with the welter of purely formal structures, rules and procedures obviously was not sufficient to prevent the company's meltdown, covered in a haze of financial and managerial scandals. The problem lay, not in the form, but in the substance, in the lack of moral integrity of those ultimately entrusted with the company's direction.

Necessary for constructing my argument is the recognition that 'governance' comes from 'government' and, as such, is normally associated with the running of a state. It was in this context that Aristotle developed his treatise on *The Politics*. Chapters three and four represent the effort to extend the meaning of 'government' analogously from its original turf in Greek city-states to the realm of modern corporations, including multinational enterprises. The comparison is carried out on a triple basis: the people who comprise them, their forms of organization and the specific ends they pursue. Special attention is directed to the notion of citizenship as it applies not only to the business organization or firm as a whole (corporate citizenship) but also to the different shareholders and stakeholder groups as citizens of the corporate polity.

In continuation, chapters five to seven flesh out the analogy between different state and corporate regimes, using Aristotle's classification grounded on a twofold criterion: the number of rulers and whether those rulers seek the common good or their own individual good. Each kind of regime is later on exemplified by an actual corporation: Fiat (corporate tyranny), Cheung Kong Holdings and Whampoa Limited (corporate monarchy), Abelardo Investment and Manufacturing Corporation/AIMC (corporate oligarchy), Banco Popular Español (corporate aristocracy), United Airlines (corporate democracy) and IDOM Engineering Consultancy (corporate polity). Corporate narratives come from the world over – Italy, China, Philippines, Spain and the United States – and they stand for a variety of sectors, from the automotive industry through finance, flour-milling and real estate to airlines. Furthermore, companies come in all sizes, from relatively small, family-owned ones to huge publicly listed multinational corporations, leaders in their field.

Chapter eight brings together some concluding remarks on the true nature of corporate governance, now envisioned to be a form of Aristotelian *praxis* (roughly, 'practice'). Steps are outlined to initiate an authentic and effective corporate governance reform premised on the education of board directors, particularly on the ethical and political aspects of their function. It is indeed remarkable that, in the end, the secret of good corporate governance can be found in the governors' education in the virtues, for, without the virtues, neither the goods nor the objectives that a corporation should seek could be properly identified, nor the the rules, procedures and structures it should follow correctly formulated, interpreted and implemented.

Perhaps unconsciously, the majority of prescriptions for corporate governance reform draw inspiration from a political theory obsessed with finding justifications for the uneven distribution of power, and hence, one that is constantly looking for ways to avoid abuse. Ultimately, what this political theory endeavours to do is to prevent one party from eliminating the others, simply because of divergent views of the good. The solution proposed consists in the rules of procedural justice. Purportedly, we cannot help but arrive and agree on them, departing from an original position of ignorance regarding our own particularities and preferences. Abstract reason and a desire for equality are the only useful guides. Another version of this theory insists on a fundamentally market-based approach to sort out our differences, without having to renounce them. After all, in a properly functioning market, needs are satisfied and conflicts resolved, not through the use of power but through free exchange. Moreover, personal beliefs are kept safe because they are apparently of no interest to other market players. Nonetheless, sufficient experimentation has been carried out with these alternatives to realize that they lead to a dead end.

Classical political theory, on the other hand, inquires above all about the best regime in the understanding that that would represent the best life for man, who is by nature a social creature. Such a regime not only allows for the satisfaction of material, external goods, but, more importantly, it permits citizens to develop themselves spiritually and internally, that is, to acquire and to perfect the requisite human virtues or excellences. This is what good government consists in; not in the mere provision of material goods or in the mechanical observance of purely formal and procedural rules. Good corporate governance should not be very far from this. It comes as no surprise, therefore, that classical political theory emphasizes the education of the prince as its main concern. In the corporate context, we would do well to take the cue and concentrate before anything else on the ethical and political education of corporate rulers, board members and directors.

I was indeed fortunate to be appointed Visiting Scholar at the Policy and Leadership Studies Department of the National Institute of Education of Singapore in the final stretch of my research and writing in the summer of 2007. I would like to take advantage of this opportunity to thank the members of the department for their support, stimulating conversation and, most of all, friendship. I wish to acknowledge a special debt of gratitude to Professor Ong Kim Lee, the Department Chair, and to Professor Jude Chua Soo Meng, who introduced me to this distinguished team of scholars. During my all too brief stay with them, I certainly felt inspired and empowered with their dedication to education. I could only hope that this book qualifies as a fitting contribution to their noble efforts.

Alejo José G. Sison
Ravenahl
Singapore
Summer of 2007

Contents

1. Changing conventional wisdom: the firm is not a money-making machine

I BUSINESS 'COMMON SENSE'

There are a few simple things that anyone who comes in contact with a firm – and past a certain age, that makes almost everybody – should know: in a firm there are people or groups of people called 'owners'. They are the ones who put in the money, thanks to which the firm is able to operate and, in exchange, the rest of society recognizes their right to call the shots. In other words, despite the boss's self-sufficient airs and penchant for ordering everyone else around, he's a mere stand-in for his own boss, the real boss, that is, the owners.

Next is that owners put their money in the firm expecting some rewards. They do not do so out of selflessness, love of neighbour or some other lofty ideal. They just expect to earn more money after a given time, hopefully, not too long. That is the logic of investment. Owners are entitled to the surplus money the firm generates for having parted with their money in the first place and allowing other people (managers and workers) to use that capital productively. Of course there are several ways of investing money and, generally, the risk each one entails is directly proportional to the possible gains. Nonetheless, a keen investor is precisely the one who is able to choose from among the different options that which yields maximum returns. In principle, therefore, business owners or capitalists wager their money on the best investment opportunity, the one that, in their minds, would probably give them the greatest profits.

Thirdly, an individual begins to form part of a firm once he has signed a contract. For some it would be an employment contract, for others, a supplier's contract, and for still others, a buyer's contract, and so on. From a legal perspective, therefore, the firm is nothing more than a bundle of such contracts, and these more or less formal agreements 'to do X in exchange for Y' are the links that bind any given party to it. It is presupposed, moreover, that anyone who enters into a contract with a firm does so by his own free will and volition, and not under duress. Whatever his particular motives may be is nobody's business, as long as he abides by the terms and conditions of the contract. It is sufficient that the two parties to a contract freely give their consent for such an agreement to be binding and enforceable. Kibitzers are admonished to hold their peace and refrain from interfering.

And finally, just as owners invest in a firm to maximize returns, correspondingly, firms are supposed to maximize value for investors as a whole. Oftentimes this means doing whatever it takes to raise a firm's share price, above all. Certainly there may be other things that a firm can do in the process, such as producing goods and services that the market demands at a price with which consumers would be agreeable. But that is simply a means to the end of increasing share or investment value. This is the one true standard with which a firm's success is to be measured.

These truisms form the kernel of what are perhaps the three most influential theories in our understanding of the modern firm, namely, 'the nature of the firm' according to Ronald Coase, 'agency theory' from Michael Jensen and William Meckling, and the 'shareholder or financial theory' of the firm as formulated by Milton Friedman. Their inclusion in what has come to be business 'common sense' is very revealing of how these doctrines have triumphed in shaping our thinking.

In the article 'The nature of the firm', first published in 1937, Ronald Coase attempted to respond to what was in fact a very simple question: why carry out production through the firm instead of the market (Coase, 1937)? Given an efficient market where the value of goods and services is determined through free exchange, why not allow the price mechanism itself to coordinate production? Why have recourse to an entrepreneur to manage production through a hierarchical organization such as the firm?

Coase's response was equally plain, although not completely satisfactory, as we shall see later on. A firm exists in order to reduce 'transaction costs'; its true 'nature' lies in its ability to drive 'transaction costs' down and thereby improve production efficiency compared to the market. Transaction costs are the 'extra costs' associated with conducting a deal, be it in terms of money, time or any other inconvenience. These could refer, for example, to the 'extra costs' incurred by the entrepreneur when scouting around for workers in the open market and having to negotiate short-term contracts with them. Such costs could be saved if workers were somehow locked in already in the firm by virtue of employment contracts. In response to changing market demands, workers could then simply be ordered around by superiors to carry out different tasks instead of renegotiating with them each time. In a commentary more than half a century later, Coase remained unmoved in that the purpose of 'The nature of the firm' was to establish cost as the deciding factor in producing goods and services through the firm instead of the market (Coase, 1991b: 61–74).

While Coase may have given an interesting first response to the question why firms exist, he nevertheless admittedly failed to explain how exactly firms reduce transaction costs (Coase, 1991a, 1991b). For this we will have to turn to the work of Michael Jensen and William Meckling.

In their ground-breaking article, 'The theory of the firm: managerial behavior, agency costs, and ownership structure', Jensen and Meckling (1976) pick up from where Coase had left off and affirm that firms reduce transaction costs largely through the establishment of so-called 'agency relationships'. Agency relationships generally take the form of contracts, although not necessarily explicit or formal ones. These stipulate that one party (the *agent*) is to perform a specific service on behalf of another (the *principal*), receiving from the latter some decision-making power for this purpose (Jensen and Meckling, 1976). In the context of the firm, we could think of the owners and other investors as the principals, and of the managers and other employees as the agents. In other words, it is through the hierarchy implicit in the agency relationship or contract that transaction costs within the firm trump those of producing in the open market.

The problem, however, is that principals cannot be continually monitoring agents. Hence, two sorts of difficulties arise: one is called 'adverse selection' and the other 'moral hazard' (Eisenhardt, 1989: 58). Adverse selection describes the case in which an agent misrepresents his ability to do the work agreed upon or adopts decisions inconsistent with the contractual goals or the principal's preferences. For example, because prospective employers cannot accurately gauge beforehand the quality of work candidates to a certain post could perform, these could always claim to do a better job than what they are in fact able to do. It could even be that they are out of a job and seeking employment precisely because of their incompetence. In such a situation, bad workers would have been 'adversely selected' to be the only ones available in the labour market, to the dismay of principals or employers.

Moral hazard occurs, on the other hand, when agents shirk their tasks or do not put forth their best efforts. For instance, if a factory worker received the same daily wage as another, regardless of the quantity and the quality of the output, we could say that he has no incentive whatsoever to improve productivity. On the contrary, he faces the 'moral hazard' of exerting the minimum indispensable effort to earn the agreed upon salary. Once again, it is the principals or employers who stand to lose.

As we have seen in the discussion of adverse selection and moral hazard, there is no guarantee that agents will always act in the best interests of principals. Rather, agents are under a constant temptation to maximize their own interests, even at the expense of the principals themselves. This divergence between the actual interests of principals and those of agents inevitably generates additional costs. These agency costs are the residual costs incurred either by the principal, when implementing measures to control the agent's behaviour, or by the agent, when striving to demonstrate commitment to the principal's goals. Whichever way, these agency costs result in a failure to maximize the principal's wealth or resources.

The challenge now lies in devising a mechanism that ensures, to the extent possible, an effective alignment of interests between agents and principals, thereby reducing the aforementioned agency costs (Shankman, 1999: 321). This is achieved through the careful formulation of contracts, so much so that principals are able to protect their interests and maximize their utility in the event of conflicts. To do so contracts should be crafted taking into account several assumptions regarding agents (self-interest, limited rationality, risk aversion), organizations (goal conflict among members) and information (assymetry) (Shankman, 1999: 332).

In a famous essay, 'The social responsibility of business is to increase its profits', the Nobel laureate economist Milton Friedman defends the role of shareholders as the owners or principals of the firm (Friedman, 1970). Therefore, the primary obligation of managers as agents of shareholder–owners is 'to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom' (Friedman, 1970). In a free-enterprise system, there is no room for such a thing as 'the social responsibilities of business', for responsibilities could only accrue to individuals, never to groups such as corporations. Certainly, as an individual, a manager or executive may recognize or voluntarily assume some 'social responsibility' towards his community or church, for instance. 'But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy; not the money of his employers or the time or energy he has contracted to devote to their purposes' (Friedman, 1970). At best, the 'social responsibility of business' should be set aside as an empty rhetorical flourish.

Let us now examine how these business truisms square with a firm called Tasubinsa.

II TASUBINSA: AN UNCOMMON BUSINESS

Tasubinsa (Talleres Auxiliares de Subcontratación Industrial Navarra, Sociedad Anónima) was constituted as a not-for-profit 'special employment centre' on 29 December 1989 through an agreement between the

Navarre Regional Autonomous Government and ANFAS (Asociación navarra a favor de las personas con discapacidad psíquica), a local association that works in favour of people with mental disabilities. Special employment centres were created by the Spanish Law on the Social Integration of the Handicapped (Ley 13/1982 of 7 April, articles 41 to 46) to provide these members of society with productive and gainful work in keeping with their personal characteristics. This law obliges both state and privately owned companies with more than 50 employees to set aside at least 2 per cent of the total number of jobs for the handicapped. Alternative measures consist in the purchase of goods or services from special employment centres or from a self-employed worker with a disability, or in donations to a foundation dedicated to the integration of the disabled (Real Decreto 27/2000 of 14 January). Failure to comply with these provisions results in substantial fines and exclusion from government contracts. Tasubinsa engages in the manufacturing and assembly of parts for automobiles, home appliances, vending machines, electronic apparatuses, and paper and plastic products. Tasubinsa also offers logistics, landscaping and janitorial services to different companies within Navarre. Towards the end of 2005, it had around 90 firms in its portfolio of clients, some of which were even located abroad.

More than 90 per cent of Tasubinsa employees have mental, physical or sensorial handicaps as certified by the Labour Ministry. The rest of the workers are the professionals indispensable for the proper functioning of the organization. The great majority of the mentally handicapped have a dysfunction equivalent of around 33 to 65 per cent less than normal. Associated with Tasubinsa are several 'occupational centres' for those whose mental disability currently impedes them from working in a special employment centre. Some occupational centres prepare individuals for future work in a special employment centre, helping them acquire the requisite skills, while others cater to those already past their productive years and who most likely suffer from premature aging, which among the mentally disabled sets in at around 45 years of age. Other formulas used by Tasubinsa for the integration of the handicapped include 'work enclaves' (enclaves laborales), 'mobile brigades' (brigadas móviles) and 'jobs with individual support' (empleo con apoyo individual). Work enclaves were set up by the Labour Ministry (Real Decreto 290/2004 of 20 February) as some sort of half-way house between a job in a special employment centre and ordinary employment. Work enclaves allow groups of workers from a special employment centre to render services to a partner-firm within the latter's premises for a period of between three months and three years, after which the partner-firm is expected to hire at least some of those workers permanently. Mobile brigades typically provide cleaning or gardening