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Chapter 12

Corporate Governance and Business Ethics

Chapter Outline

Learning Objectives

LO 12-1 Describe the shared value creation framework and its relationship to competitive advantage.

LO 12-2 Explain the role of corporate governance.

LO 12-3 Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.

LO 12-4 Evaluate the board of directors as the central governance mechanism for public stock companies.

LO 12-5 Evaluate other governance mechanisms.

LO 12-6 Explain the relationship between strategy and business ethics.

CHAPTERCASE 12

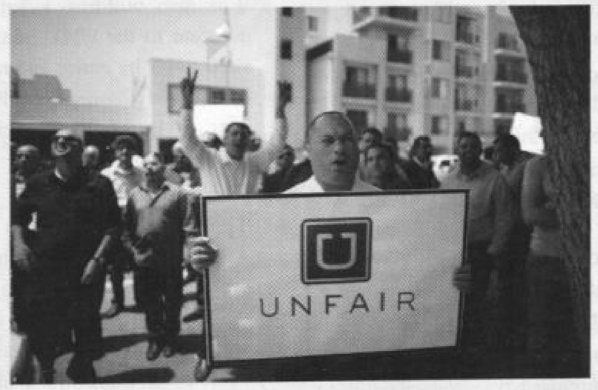
Uber: Most Ethically Challenged Tech Company?

IN THE SUMMER of 2015 Uber surpassed a valuation of over $50 billion and became the most valuable private startup ever. Yet in the wake of its business success, Uber leaves a trail of lawsuits and accusations.

RECORD-BREAKING GROWTH

Only one other new venture—Facebook—has ever reached a $50 billion valuation for a private, venture-capital-backed firm. But it took Facebook seven years to reach this mark; Uber only five. For perspective, the valuation of the car rental giant Hertz, with some 150 locations, a fleet of 500,000 cars, and some 30,000 employees, is only about a fifth of Uber's valuation.

Uber reached this astronomical valuation because it successfully expanded both in the United States and globally to more than 300 cities. Uber's popularity grows exponentially, as it already transports millions of riders daily, and continues to expand rapidly here and abroad. Although Uber is still losing money as it continues to subsidize customer fares, its revenues race ahead, from $400 million in 2014 to $2 billion in 2015.



Protest against Uber
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UBER'S BEGINNING

Uber started in 2008 when Travis Kalanick and Garrett Camp were bothered by the inconvenience of getting a cab in San Francisco. The two tech entrepreneurs worked up a prototype of a cab-hailing app and won the first round of funding a year later to further develop the service. They chose the name Uber when inspired by the idea of using a Mercedes limousine and driver instead of a regular cab—the German word *über* means "superior." By 2010, Uber debuted its service in San Francisco.

ETHICALLY CHALLENGED?

Despite its meteoric rise, not all is roses for Uber. Venture capitalist Peter Thiel called Uber the "most ethically challenged company in Silicon Valley."[1] But then, Thiel, the billionaire co-founder of PayPal and Palantir (a big data analytics company), is also an investor in Lyft, Uber's main competitor. Lyft has a valuation of only $2.5 billion. Thiel argues that Uber is pushing the envelope of what is acceptable, ethical, and even legal with all its stakeholders, including its dealings with regulators, government bodies at different levels, freelance drivers, journalists, and competitors. Thiel further argues that Uber is on the cusp of going too far.

ITS OWN RIVAL

Echoing Thiel's assessment, *The Wall Street Journal (WSJ)* argued Uber itself—rather than Lyft or old-line taxi and limo services—is its own biggest threat, thereby functioning as its own biggest rival. The competitive tactics and comments by Uber executives are harming the company's reputation and becoming a liability, the *WSJ* argues. The company's short history provides rich examples for such claims.

- **Open disregard for laws, rules, and regulations.** Within months of its San Francisco launch, the local Metro Transit Authority and the state Public Utilities Commission each ordered Uber to cease and desist. They argued that Uber was operating as a taxi service without proper licensing. Pushback and injunctions followed in major domestic markets, including New York City and Los Angeles, and internationally in Toronto, Paris, London, Berlin, and Delhi. Ignoring such warnings, Uber continues to expand.
- **Dynamic pricing**. While the taxi industry operates under regulation with fixed pricing, Uber opts for the dynamic pricing used by airlines, hotels, and other industries. That is, Uber's fares go up or down based on real-time supply and demand. So during a

snowstorm or on New Year's Eve, short Uber rides can cost hundreds of dollars. CEO Kalanick argues that surge pricing efficiently matches supply and demand. But many Uber users see it as price gouging and vent their frustrations on Twitter and Facebook.

- **Competitive tactics**. Lyft, the competing ride-share app, accused Uber of ordering over 5,000 rides from Lyft, and then canceling, so Lyft drivers lost business from legitimate rides. Reportedly Uber tells its drivers in New York that they cannot work for both Uber and Lyft because of city regulations; the city says Uber's claim is untrue. Accusers say that Uber brand ambassadors actively target successful drivers from Lyft and other competitors to defect.
- **Poisoning sources of funding**. Kalanick reportedly poisoned Lyft's efforts to raise venture capital, telling investors, "before you decide whether you want to invest in [Lyft], just make sure you know that we are going to be fund-raising immediately after."[2]
- **Death of a child**. An Uber driver, while between fares, tragically struck and killed 6-year-old Sophia Liu in a crosswalk in San Francisco. Claims arose that the driver was busy using the Uber app at the time and did not see the girl. Uber, rather than dealing with this public relations disaster by expressing condolences to the family for their loss, focused on its legal posture and coldly denied all liability, making sure that people knew that the driver was between Uber jobs.
- **Sexist ad campaign**. Uber's office in Lyon, France, ran a sexist ad campaign that promised rides with "avions de chasse" as drivers, which is French for fighter jets, but colloquially it means "hot chicks." The ads were accompanied by revealing photos of models. Uber headquarters canceled the ad campaign and apologized for the "clear misjudgment by the local team."
- **Attacking critics**. In late 2014, Uber senior executive Emil Michael was heard to say that Uber should spend a million dollars to hire private investigators to dig up dirt on journalists who wrote damaging pieces on Uber, with particular focus on Sarah Lacy, of tech blog PandoDaily. When the remarks became public, he apologized. Uber CEO Kalanick said that Michael's comments were "a departure from our values and ideals," but Michaels was not otherwise disciplined.
- **Stealth tech transfer**. In the spring of 2015, Uber opened its Advanced Tech Center in Pittsburgh to develop autonomous cars and sophisticated mapping services. Uber gained access to scientists when it funded research at Carnegie Mellon University's National Robotics Engineering Center (NREC). A few months later, Uber poached entire NREC research teams with signing bonuses, twice the salaries, and stock options. It is also building a super-modern research center adjacent to the CMU campus. The NREC was left a shell, with its entire future in question. To add insult to injury to Carnegie Mellon, Uber rented a billboard next to its computer science department, reading, "We are looking for the best software engineers in Pittsburgh."
- **Thumbing its nose**. With the announced agenda of its Advanced Tech Center, Uber moves into direct conflict with one of its biggest partners and investors, Google, the leader in online maps and a pioneer in self-driving cars. After successfully demonstrating an autonomous vehicle on California's highways and cities, Google is hopeful that its self-driving car technology will be viable by 2020 for widespread adoption.[3]

You will learn more about Uber from reading this chapter; related questions appear on page 419.

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THE UBER CHAPTERCASE illustrates how intricate and intertwined business ethics issues and competitive advantage can be. With over $50 billion in valuation, Uber is riding high as the world's most valuable private start-up firm. Its huge cash pile fuels its rapid expansion in the United States and abroad. It allows Uber to subsidize fares and to attract more drivers to its platform. All this is done to create network effects based on a large installed base of Uber drivers and users. In what is likely to be a winner-take-all market, Uber is planning to be the winner in the ride-hailing business. Some caution that Uber is risking going too far in its competitive tactics. Uber is certainly pushing the envelope with what is ethical as well as legal in its business practices. This strong-arm approach might harm the company's reputation and negatively impact its competitive advantage.

In this chapter, we wrap up our discussion of strategy implementation and close the circle in the AFI framework by studying two important areas: corporate governance and

business ethics. We begin with the *shared value creation framework* to illuminate the link between strategic management, competitive advantage, and society more fully. We then discuss effective *corporate-governance* mechanisms to direct and control the enterprise, which a firm must put in place to ensure pursuit of its intended goals. Next, we study *business ethics*, which enable managers to think through complex decisions in an increasingly dynamic, interdependent, and global marketplace. The vignettes in the ChapterCase documenting controversial decisions, tactics, and statements by Uber highlight the link between business ethics and competitive advantage. We conclude with "Implications for the strategist."

12.1 The Shared Value Creation Framework

LO 12-1

Describe the shared value creation framework and its relationship to competitive advantage.

The shared value creation framework provides guidance to managers about how to reconcile the economic imperative of gaining and sustaining competitive advantage with corporate social responsibility (introduced in Chapter 1).[4] It helps managers create a larger pie that benefits both shareholders and other stakeholders. To develop the shared value creation framework, though, we first must understand the role of the public stock company.

PUBLIC STOCK COMPANIES AND SHAREHOLDER CAPITALISM

The public stock company is an important institutional arrangement in modern, free market economies. It provides goods and services as well as employment, pays taxes, and increases the standard of living. There exists an implicit contract based on trust between society and the public stock company. Society grants the right to incorporation, but in turn expects companies to be good citizens by adding value to society.

To fund future growth, companies frequently need to go public. Uber, featured in the ChapterCase, is one of the few companies that achieved a huge valuation prior to an initial public offering. Private start-up companies valued at a billion dollars or more are called *unicorns*, because at one time they seemed as rare as the mythical beast. But their elusiveness has changed. The tech sector now has the lion's share: some 75 unicorns valued at $1 billion or more, for a total of $273 billion.[5] The top five most valuable private start-up companies (as of the summer of 2015) are Uber, Airbnb, Snapchat, Palantir Technologies, and SpaceX (rocket science). These new ventures may eventually go public such as Facebook did in 2012, but as long as they remain private they do not have to follow the stringent financial reporting and auditing requirements that public stock companies do. Consider that there may be a connection between firm structure and the degree that it integrates ethics. Not needing to expose themselves to as much public scrutiny as a publicly traded company also allows unicorns such as Uber to push the envelope in their legal and ethical business practices.

In capital markets, private companies that achieve a valuation of $1 billion or greater are rare enough to be called unicorns.
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Exhibit 12.1 depicts the levels of hierarchy within a public stock company. The state or society grants a charter of incorporation to the company's shareholders—its owners, who legally own stock in the company. The shareholders appoint a board of directors to govern

EXHIBIT 12.1 /

The Public Stock Company: Hierarchy of Authority

and oversee the firm's management. The managers hire, supervise, and coordinate employees to manufacture products and provide services. The public stock company enjoys four characteristics that make it an attractive corporate form:[6]

1. *Limited liability for investors.* This characteristic means that the shareholders who provide the risk capital are liable only to the capital specifically invested, and not for other investments they may have made or for their personal wealth. Limited liability encourages investments by the wider public and entrepreneurial risk-taking.
2. *Transferability of investor ownership* through the trading of shares of stock on exchanges such as the New York Stock Exchange (NYSE) and NASDAQ,[7] or exchanges in other countries. Each share represents only a minute fraction of ownership in a company, thus easing transferability.
3. *Legal personality*—that is, the law regards a non-living entity such as a for-profit firm as similar to a person, with legal rights and obligations. Legal personality allows a firm's continuation beyond the founder or the founder's family.
4. *Separation of legal ownership and management control.*[8] In publicly traded companies, the stockholders (the principals, represented by the board of directors) are the legal owners of the company, and they delegate decision-making authority to professional managers (the agents).

The public stock company has been a major contributor to value creation since its inception as a new organizational form more than a hundred years ago. Michael Porter and others, however, argue that many public companies have defined value creation too narrowly in terms of financial performance.[9] This in turn has contributed to some of the *black swan events* discussed in Chapter 1, such as large-scale accounting scandals and the global financial crisis. Managers' pursuit of strategies that define value creation too narrowly may have negative consequences for society at large, as evidenced during the global financial crisis. This narrow focus has contributed to the loss of trust in the corporation as a vehicle for value creation, not only for shareholders but also other stakeholders and society.

Nobel laureate Milton Friedman stated his view of the firm's social obligations: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[10] This notion is often captured by the term **shareholder capitalism**. According to this perspective, shareholders—the providers of the necessary risk capital and the legal owners of public companies—have the most legitimate claim on profits. When introducing the notion of *corporate social responsibility* (CSR) in Chapter 1, though, we noted that a firm's obligations frequently go beyond the economic responsibility to increase profits, extending to ethical and philanthropic expectations that society has of the business enterprise.[11]

shareholder capitalism Shareholders—the providers of the necessary risk capital and the legal owners of public companies—have the most legitimate claim on profits.

A recent survey measured attitudes toward business responsibility in various countries. The survey asked the top 25 percent of income earners holding a university degree in each country surveyed whether they agree with Milton Friedman's philosophy that "the social responsibility of business is to increase its profits."[12] The results, displayed in Exhibit 12.2, revealed some intriguing national differences. The United Arab Emirates (UAE), a small and business-friendly federation of seven emirates, had the highest level of agreement, at 84 percent. The top five also included a number of Asian countries (Japan, India, South Korea, and Singapore), where roughly two-thirds agreed.

The countries where the fewest people agreed with Friedman's philosophy were China, Brazil, Germany, Italy, and Spain; fewer than 40 percent of respondents in those countries supported an exclusive focus on shareholder capitalism. Although they have achieved a

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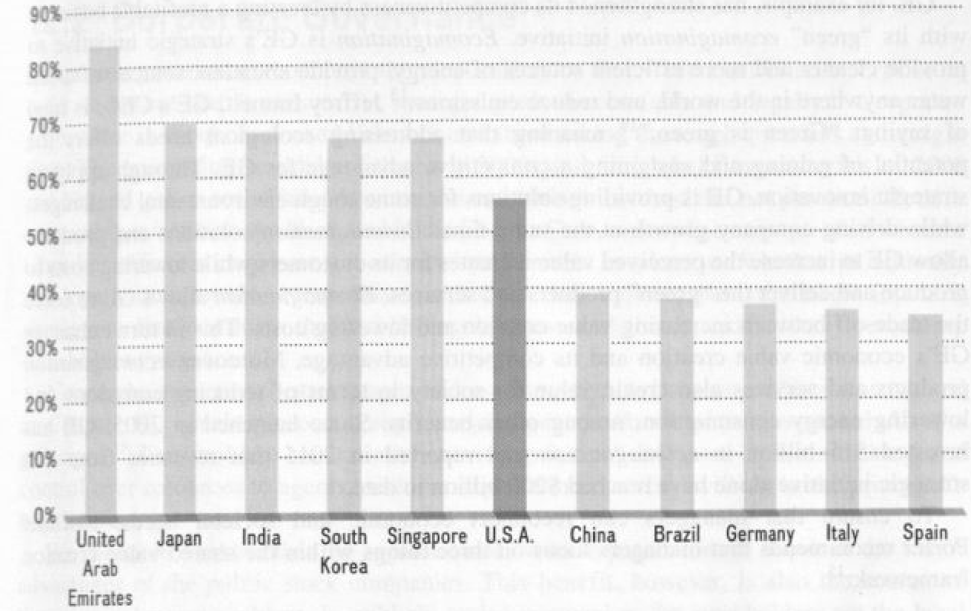

EXHIBIT 12.2 /

Global Survey of Attitudes toward Business Responsibility

The bar chart indicates the percentage of members of the "informed public" who "strongly agree/somewhat agree" with Milton Friedman's philosophy, "the social responsibility of business is to increase its profits."

Source: Author's depiction of data from Edelman's (2011) Trust Barometer as included in "Milton Friedman goes on tour," The Economist, January 27, 2011.

high standard of living, European countries such as Germany have tempered the free market system with a strong social element, leading to so-called *social market economies.* The respondents from these countries seemed to be more supportive of a *stakeholder strategy* approach to business. Some critics, however, would argue that too strong a focus on the social dimension contributed to the European debt crisis because sovereign governments such as Greece, Italy, and Spain took on nonsustainable debt levels to fund social programs such as early retirement plans, government-funded health care, and so on. The United States placed roughly in the middle of the continuum. In particular, a bit more than half (56 percent) of U.S. respondents subscribed to Friedman's philosophy.

CREATING SHARED VALUE

In contrast to Milton Friedman, Porter argues that executives should not concentrate exclusively on increasing firm profits. Rather, the strategist should focus on creating *shared value,* a concept that involves creating economic value for shareholders while also creating social value by addressing society's needs and challenges. He argues that managers need to reestablish the important relationship between superior firm performance and societal progress. This dual point of view, Porter argues, will not only allow companies to gain and sustain a competitive advantage but also reshape capitalism and its relationship to society.

The **shared value creation framework** proposes that managers maintain a dual focus on shareholder value creation and value creation for society. It recognizes that markets are defined not only by economic needs but also by societal needs. It also advances the perspective that *externalities* such as pollution, wasted energy, and costly accidents actually create *internal costs,* at least in lost reputation if not directly on the bottom line. Rather than pitting economic and societal needs in a trade-off, Porter suggests that the two can be reconciled to create a larger pie. The shared value creation framework seeks to enhance a firm's competitiveness by identifying connections between economic and social needs, and then creating a competitive advantage by addressing these business opportunities.

shared value creation framework A model proposing that managers have a dual focus on shareholder value creation and value creation for society.

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GE, for example, has strengthened its competitiveness by creating a profitable business with its "green" *ecomagination* initiative. *Ecomagination* is GE's strategic initiative to provide cleaner and more efficient sources of energy, provide abundant sources of clean water anywhere in the world, and reduce emissions.[13] Jeffrey Immelt, GE's CEO, is fond of saying: "Green is green,"[14] meaning that addressing ecological needs offers the potential of gaining and sustaining a competitive advantage for GE. Through applying strategic innovation, GE is providing solutions for some tough environmental challenges, while driving company growth at the same time. *Ecomagination* solutions and products allow GE to increase the perceived value it creates for its customers while lowering costs to produce and deliver the "green" products and services. *Ecomagination* allows GE to solve the trade-off between increasing value creation and lowering costs. This in turn enhances GE's economic value creation and its competitive advantage. Moreover, *ecomagination* products and services also create value for society in terms of reducing emissions and lowering energy consumption, among other benefits. Since launched in 2005, GE has invested $15 billion in *ecomagination* and reported in 2015 that revenues from this strategic initiative alone have reached $200 billion to date.

To ensure that managers can reconnect economic and societal needs, Michael Porter recommends that managers focus on three things within the shared value creation framework:[15]

1. **Expand the customer base to bring in *nonconsumers*** such as those at the *bottom of the pyramid*—the largest but poorest socioeconomic group of the world's population. The bottom of the pyramid in the global economy can yield significant business opportunities, which—if satisfied—could improve the living standard of the world's poorest. Muhammad Yunus, Nobel Peace Prize winner, founded Grameen Bank in Bangladesh to provide small loans (termed *microcredit)* to impoverished villagers, who used the funding for entrepreneurial ventures that would help them climb out of poverty. Other businesses have also found profitable opportunities at the bottom of the pyramid. In India, Arvind Mills offers jeans in a ready-to-make kit that costs only a fraction of the high-end Levi's. The Tata group sells its Nano car for around 150,000 rupees (less than $2,500), enabling more Indian families to move from mopeds to cars and adding up to a substantial business.
2. **Expand traditional internal firm value chains to include more nontraditional partners** such as *nongovernmental organizations* (NGOs).
   NGOs are nonprofit organizations that pursue a particular cause in the public interest and are independent of any governments. Habitat for Humanity and Greenpeace are examples of NGOs.
3. **Focus on creating new *regional clusters*** such as Silicon Valley in the United States, Electronic City in Bangalore, India, and Chilecon Valley in Santiago, Chile.

In line with *stakeholder theory* (discussed in Chapter 1), Porter argues that these strategic actions will lead to a larger pie of revenues and profits that can be distributed among a company's stakeholders. General Electric, for example, recognizes a convergence between shareholders and stakeholders to create shared value. It states in its governance principles: "Both the board of directors and management recognize that the long-term interests of shareowners are advanced by responsibly addressing the concerns of other stakeholders and interested parties, including employees, recruits, customers, suppliers, GE communities, government officials, and the public at large."[16] To ensure that convergence indeed takes place, companies need effective governance mechanisms, which we discuss next.

12.2 Corporate Governance

LO 12-2

Explain the role of corporate governance.

corporate governance A system of mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.

Corporate governance concerns the mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.[17] Corporate governance is about checks and balances and about asking the tough questions at the right time. The accounting scandals of the early 2000s and the global financial crisis of 2008 and beyond got so out of hand because the enterprises involved did not practice effective corporate governance. As discussed in the ChapterCase, some observers question whether Uber has effective corporate-governance mechanisms in place, or whether its ethically and legally questionable competitive tactics and decisions are part of a larger intended strategy to first dominate the taxi-hailing business and then to address any remaining stakeholder grievances.

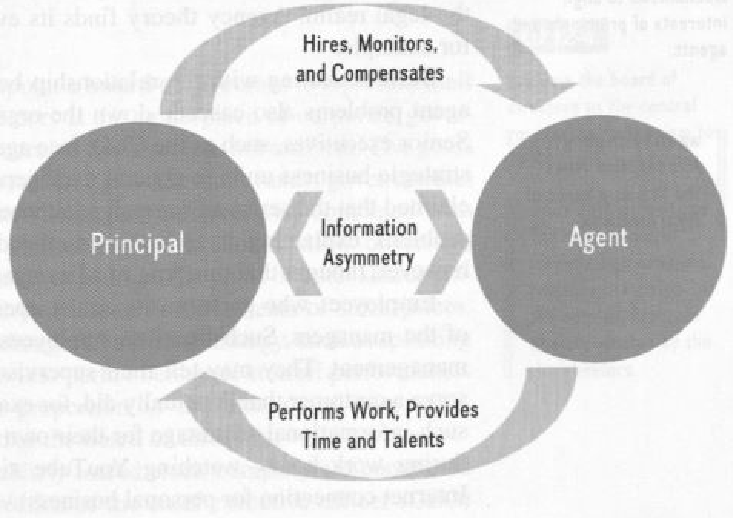
Corporate governance attempts to address the *principal–agent problem* (introduced in Chapter 8), which can occur any time an agent performs activities on behalf of a principal.[18] This problem can arise whenever a principal delegates decision making and control over resources to agents, with the expectation that they will act in the principal's best interest.

We mentioned earlier that the separation of ownership and control is one of the major advantages of the public stock companies. This benefit, however, is also the source of the principal–agent problem. In publicly traded companies, the stockholders are the legal owners of the company, but they delegate decision-making authority to professional managers. The conflict arises if the agents pursue their own personal interests, which can be at odds with the principals' goals. For their part, agents may be more interested in maximizing their total compensation, including benefits, job security, status, and power. Principals desire maximization of total returns to shareholders.

The risk of opportunism on behalf of agents is exacerbated by *information asymmetry:* the agents are generally better informed than the principals. Exhibit 12.3 depicts the principal–agent relationship.

Managers, executives, and board members tend to have access to *private information* concerning important company developments that outsiders, especially investors, are not privy to. Often this informational advantage is based on timing—insiders are the first to learn about important developments before the information is released to the public. Although possessing insider information is not illegal and indeed is part of an executive's job, what *is* illegal is acting upon it through trading stocks or passing on the information to others who might do so. Insider-trading cases, therefore, provide an example of egregious exploitation of information asymmetry. The hedge fund Galleon Group (holding assets worth $7 billion under management at its peak) was engulfed in an insider-trading scandal involving private information about important developments at companies such as Goldman Sachs, Google, IBM, Intel, and P&G.[19] Galleon Group's founder, Raj Rajaratnam, the mastermind behind a complex network of informants, was sentenced to 11 years in

EXHIBIT 12.3 / The Principal–Agent Problem



prison and fined more than $150 million. In one instance, an Intel manager had provided Rajaratnam with internal Intel data such as orders for processors and production runs. These data indicated that demand for Intel processors was much higher than analysts had expected. Galleon bought Intel stock well before this information was public to benefit from the anticipated share appreciation.

In another instance, Rajaratnam benefited from insider tips provided by Rajat Gupta, a former McKinsey chief executive who served on Goldman Sachs' board. Often within seconds after a Goldman Sachs board meeting ended, Gupta called Rajaratnam. In one of these phone calls, Gupta revealed the impending multibillion-dollar liquidity injection by Warren Buffett into Goldman Sachs during the midst of the global financial crisis. This information allowed the Galleon Group to buy Goldman Sachs shares before the official announcement about Buffett's investment was made, profiting from the subsequent stock appreciation. In another call, Gupta informed Rajaratnam that the investment bank would miss earnings estimates. Based on this insider information, the Galleon Group was able to sell its holdings in Goldman Sachs' stock prior to the announcement, avoiding a multimillion-dollar loss.[20]

Information asymmetry also can breed *on-the-job consumption*, perquisites, and excessive compensation. Although use of company funds for golf outings, resort retreats, professional sporting events, or elegant dinners and other entertainment is an everyday manifestation of on-the-job consumption, other forms are more extreme. Dennis Kozlowski, former CEO of Tyco, a diversified conglomerate, used company funds for his $30 million New York City apartment (the shower curtain alone was $6,000) and for a $2 million birthday party for his second wife.[21] John Thain, former CEO of Merrill Lynch, spent $1.2 million of company funds on redecorating his office, while he demanded cost cutting and frugality from his employees.[22] Such uses of company funds, in effect, mean that shareholders pay for those items and activities. Thain also allegedly requested a bonus of up to $30 million in 2009 despite Merrill Lynch having lost billions of dollars and being unable to continue as an independent company. Merrill Lynch was later acquired by Bank of America in a fire sale.

LO 12-3

Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.

AGENCY THEORY

The principal–agent problem is a core part of **agency theory**, which views the firm as a nexus of legal contracts.[23] In this perspective, corporations are viewed merely as a set of legal contracts between different parties. Conflicts that may arise are to be addressed in the legal realm. Agency theory finds its everyday application in employment contracts, for example.

agency theory A theory that views the firm as a nexus of legal contracts.

Besides dealing with the relationship between shareholders and managers, principal-agent problems also cascade down the organizational hierarchy (shown in Exhibit 12.3). Senior executives, such as the CEO, face agency problems when they delegate authority of strategic business units to general managers. Uber headquarters staff in the United States claimed that the sexist ad campaign launched by its French office was based on an agency problem, explaining it as a "clear misjudgment of the local team." The local team, however, thought that this type of ad campaign would serve Uber in France well.

Employees who perform the actual operational labor are agents who work on behalf of the managers. Such frontline employees often enjoy an informational advantage over management. They may tell their supervisor that it took longer to complete a project or serve a customer than it actually did, for example. Some employees may be tempted to use such informational advantage for their own self-interest (e.g., spending time on Facebook during work hours, watching YouTube videos, or using the company's computer and Internet connection for personal business).

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The managerial implication of agency theory relates to the management functions of organization and control: The firm needs to design work tasks, incentives, and employment contracts and other control mechanisms in ways that minimize opportunism by agents. Such governance mechanisms are used to align incentives between principals and agents. These mechanisms need to be designed in such a fashion as to overcome two specific agency problems: *adverse selection* and *moral hazard.*

ADVERSE SELECTION. In general, **adverse selection** occurs when information asymmetry increases the likelihood of selecting inferior alternatives. In principal–agent relationships, for example, adverse selection describes a situation in which an agent misrepresents his or her ability to do the job. Such misrepresentation is common during the recruiting process. Once hired, the principal may not be able to accurately assess whether the agent can do the work for which he or she is being paid. The problem is especially pronounced in team production, when the principal often cannot ascertain the contributions of individual team members. This creates an incentive for opportunistic employees to free-ride on the efforts of others.

adverse selection A situation that occurs when information asymmetry increases the likelihood of selecting inferior alternatives.

MORAL HAZARD. In general, **moral hazard** describes a situation in which information asymmetry increases the incentive of one party to take undue risks or shirk other responsibilities because the costs accrue to the other party. For example, bailing out homeowners from their mortgage obligations or bailing out banks from the consequences of undue risk-taking in lending are examples of moral hazard. The costs of default are rolled over to society. Knowing that there is a high probability of being bailed out ("too big to fail") increases moral hazard. In this scenario, any profits remain private, while losses become public.

moral hazard A situation in which information asymmetry increases the incentive of one party to take undue risks or shirk other responsibilities because the costs incur to the other party.

In the principal–agent relationship, moral hazard describes the difficulty of the principal to ascertain whether the agent has really put forth a best effort. In this situation, the agent is *able* to do the work but may decide not to do so. For example, a company scientist at a biotechnology company may decide to work on his own research project, hoping to eventually start his own firm, rather than on the project he was assigned.[24] While working on his own research on company time, he might also use the company's laboratory and technicians. Given the complexities of basic research, it is often challenging, especially for nonscientist principals, to ascertain which problem a scientist is working on.[25] To overcome these principal–agent problems, firms put several governance mechanisms in place. We shall discuss several of them next, beginning with the board of directors.

LO 12-4

Evaluate the board of directors as the central governance mechanism for public stock companies.

THE BOARD OF DIRECTORS

The shareholders of public stock companies appoint a **board of directors** to represent their interests (see Exhibit 12.1). The board of directors is the centerpiece of corporate governance in such companies. The shareholders' interests, however, are not uniform. The goals of some shareholders, such as institutional investors (e.g., retirement funds, governmental bodies, and so on), are generally the long-term viability of the enterprise combined with profitable growth. Long-term viability and profitable growth should allow consistent dividend payments and result in stock appreciation over time. The goals of other shareholders, such as hedge funds, are often to profit from short-term movements of stock prices. These more proactive investors often demand changes in a firm's strategy, such as spinning out certain divisions or splitting up companies into parts to enhance overall performance. Votes at shareholder meetings, generally in proportion to the amount of ownership, determine whose representatives are appointed to the board of directors.

board of directors The centerpiece of corporate governance, composed of inside and outside directors who are elected by the shareholders.

The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO) and the oversight of the board of directors. The board of directors is composed of inside and outside directors who are elected by the shareholders:[26]

inside directors Board members who are generally part of the company's senior management team; appointed by shareholders to provide the board with necessary information pertaining to the company's internal workings and performance.

- **Inside directors** are generally part of the company's senior management team, such as the chief financial officer (CFO) and the chief operating officer (COO). They are appointed by shareholders to provide the board with necessary information pertaining to the company's internal workings and performance. Without this valuable inside information, the board would not be able to effectively monitor the firm. As senior executives, however, inside board members' interests tend to align with management and the CEO rather than the shareholders.
- **Outside directors**, on the other hand, are not employees of the firm. They frequently are senior executives from other firms or full-time professionals, who are appointed to a board and who serve on several boards simultaneously. Given their independence, they are more likely to watch out for the interests of shareholders.

outside directors Board members who are not employees of the firm, but who are frequently senior executives from other firms or full-time professionals.

The board is elected by the shareholders to represent their interests. Each director has a *fiduciary responsibility*—a legal duty to act solely in another party's interests—toward the shareholders because of the trust placed in him or her. Prior to the annual shareholders' meeting, the board proposes a slate of nominees, although shareholders can also directly nominate director candidates. In general, large institutional investors support their favored candidates through their accumulated proxy votes. The board members meet several times a year to review and evaluate the company's performance and to assess its future strategic plans as well as opportunities and threats. In addition to general strategic oversight and guidance, the board of directors has other, more specific functions, including:

- Selecting, evaluating, and compensating the CEO. The CEO reports to the board. Should the CEO lose the board's confidence, the board may fire him or her.
- Overseeing the company's CEO succession plan.
- Providing guidance to the CEO in the selection, evaluation, and compensation of other senior executives.
- Reviewing, monitoring, evaluating, and approving any significant strategic initiatives and corporate actions such as large acquisitions.
- Conducting a thorough risk assessment and proposing options to mitigate risk. The boards of directors of the financial firms at the center of the global financial crisis were faulted for not noticing or not appreciating the risks the firms were exposed to.
- Ensuring that the firm's audited financial statements represent a true and accurate picture of the firm.
- Ensuring the firm's compliance with laws and regulations. The boards of directors of firms caught up in the large accounting scandals were faulted for being negligent in their company oversight and not adequately performing several of the functions listed here.

Board independence is critical to effectively fulfilling a board's governance responsibilities. Given that board members are directly responsible to shareholders, they have an incentive to ensure that the shareholders' interests are pursued. If not, they can experience a loss in reputation or can be removed outright. More and more directors are also exposed to legal repercussions should they fail in their fiduciary responsibility. To perform their strategic oversight tasks, board members apply the strategic management theories and concepts presented herein, among other more specialized tools such as those originating in finance and accounting.

To make the workings of a board of directors more concrete, Strategy Highlight 12.1 takes a closer look at corporate governance at General Electric.[27]

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Strategy Highlight 12.1

GE's Board of Directors

The GE board is composed of individuals from the business world (chairpersons and CEOs of Fortune 500 companies spanning a range of industries), academia (business school and science professors, deans, and provosts), and government (SEC).[28] Including the board's chairperson, GE's board has 16 members. Experts in corporate governance consider that an appropriate number of directors for a company of GE's size (roughly $260 billion in market capitalization as of the summer of 2015).

At GE (as of 2015), 15 of the 16 board members (94 percent) are independent outside directors. To achieve board independence, experts in corporate governance recommend that two-thirds of its directors be outsiders. GE's board has only one inside director, Jeffrey Immelt, GE's CEO, who also serves as chairman of the board. In roughly half of U.S. public firms, the CEO of the company also serves as chair of the board of directors.

GE's board of directors meets a dozen or more times annually. With increasing board accountability in recent years, boards now tend to meet more often. Moreover, many firms limit the number and type of directorships a board member may hold concurrently. To accomplish their responsibilities, boards of directors are usually organized into different committees. GE's board has five committees, each with its own chair: the audit committee; the management development and compensation committee; the nominating, governance, and affairs committee; the risk committee; and the science and technology committee.

In general, women and minorities remain underrepresented on boards of directors across the United States and throughout most of the world. GE's board is somewhat more diverse in gender when compared with other Fortune 500 companies, which in 2014 averaged 19 percent women on their boards versus 25 percent for GE.

Generally, the larger the company, the greater its gender diversity, as demonstrated in recent years by tracking different levels of the Fortune 1000. For example, in 2014 boards of the Fortune 100 companies averaged 22 percent gender diversity; of Fortune 500 (as noted), 19 percent; and of the bottom half of the Fortune 1000, 16 percent. GE as of this writing ranks number eight in the Fortune 1000 rankings in terms of gender diversity.

Diversity in backgrounds and expertise in the boardroom is considered an asset: More diverse boards are less likely to fall victim to *groupthink*, a situation in which opinions coalesce around a leader without individuals critically challenging and evaluating that leader's opinions and assumptions.

As discussed in Strategy Highlight 12.1, Jeffrey Immelt serves not only as the chief executive officer (CEO) of GE, a roughly $260 billion conglomerate, but also as chairman of the board. This practice of **CEO/chairperson duality**—holding both the role of CEO and chairperson of the board—has been declining somewhat in recent years.[29] Among the largest 500 publicly traded companies in the United States, almost 70 percent of firms had the dual CEO-chair arrangement in 2005 (pre global financial crisis), but this number had declined to 56 percent of companies in 2012 (post global financial crisis).

CEO/chairperson duality Situation where the CEO of a publicly traded company is also the chairperson of the board of directors.

The functions of the CEO and chairperson of the board roles are distinctly different. A board of directors broadly oversees a company's business activities. The company's CEO reports to the board of directors and acts as a liaison between the company and the board. The CEO has high-level responsibilities of strategy and all other management activities of a company while the functions of the board of directors include approving the annual budget and dealing with stakeholders. Moreover, a CEO is the public face of a company or organization and takes the hit or pat on the back if a company fails or succeeds, while the board of directors is there to steer a company on behalf of shareholders.

Arguments can be made both for and against splitting the roles of CEO and chairperson of the board. On the one hand, the CEO has invaluable inside information that can help in chairing the board effectively. The benefit of a combined CEO and chair of the board is that they can act in unity to streamline and speed the decision-making process as well as strategy implementation. On the other hand, the chairperson may influence the board unduly through setting the meeting agendas or suggesting board appointees who are friendly toward the CEO. Because one of the key roles of the board is to monitor and evaluate the CEO's performance, there can be a conflict of interest when the CEO actually chairs the board.

LO 12-5

Evaluate other governance mechanisms.

OTHER GOVERNANCE MECHANISMS

While the board of directors is the central governance piece for a public stock company, several other corporate mechanisms are also used to align incentives between principals and agents, including

- Executive compensation.
- The market for corporate control.
- Financial statement auditors, government regulators, and industry analysts.

EXECUTIVE COMPENSATION. The board of directors determines executive compensation packages. To align incentives between shareholders and management, the board frequently grants **stock options** as part of the compensation package. This mechanism is based on agency theory and gives the recipient the right, but not the obligation, to buy a company's stock at a predetermined price sometime in the future. If the company's share price rises above the negotiated strike price, which is often the price on the day when compensation is negotiated, the executive stands to reap significant gains.

stock options An incentive mechanism to align the interests of shareholders and managers, by giving the recipient the right (but not the obligation) to buy a company's stock at a predetermined price sometime in the future.

The topic of executive compensation—and CEO pay, in particular—has attracted significant attention in recent years. Two issues are at the forefront:

1. The absolute size of the CEO pay package compared with the pay of the average employee.
2. The relationship between CEO pay and firm performance.

Absolute Size of Pay Package. The ratio of CEO to average employee pay in the United States is about 300 to 1, up from roughly 40 to 1 in 1980.[30] Based on a 2014 survey of CEOs among 300 large companies with revenues of at least $9 billion, the average salary for a CEO was $14 million. The five highest paid CEOs were Michael Fries of Liberty Global ($112 million), Satya Nadella of Microsoft ($84 million), Larry Ellison of Oracle ($67 million), Steven Mollenkopf of Qualcomm ($61 million), and Leslie Moonves of CBS ($57 million).[31]

CEO Pay and Firm Performance. Overall, the same survey shows that two-thirds of CEO pay is linked to firm performance.[32] The relationship between pay and performance is positive, but the link is weak at best. Although agency theory would predict a positive link between pay and performance as this aligns incentives, some recent experiments in *behavioral economics* caution that incentives that are too high-powered (e.g., outsized bonuses) may have a negative effect on job performance.[33] That is, when the incentive level is very high, an individual may get distracted from strategic activities because too much attention is devoted to the outsized bonus to be enjoyed in the near future. This can further increase job stress and negatively impact job performance.

THE MARKET FOR CORPORATE CONTROL. Whereas the board of directors and executive compensation are *internal* corporate-governance mechanisms, the *market for corporate control* is an important *external* corporate-governance mechanism. It consists of activist

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investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market. To avoid such attempts, corporate managers strive to protect shareholder value by delivering strong share-price performance or putting in place poison pills (discussed later).

Here's how the market for corporate control works: If a company is poorly managed, its performance suffers and its stock price falls as more and more investors sell their shares. Once shares fall to a low enough level, the firm may become the target of a *hostile takeover* (as discussed in Chapter 9) when new bidders believe they can fix the internal problems that are causing the performance decline. Besides competitors, so-called *corporate raiders* (e.g., Carl Icahn and T. Boone Pickens) or *private equity firms* and *hedge funds* (e.g., The Blackstone Group and Pershing Square Capital Management) may buy enough shares to exert control over a company.

In a **leveraged buyout (LBO)**, a single investor or group of investors buys, with the help of borrowed money (leveraged against the company's assets), the outstanding shares of a publicly traded company in order to take it private. In short, an LBO changes the ownership structure of a company from public to private. The expectation is often that the private owners will restructure the company and eventually take it public again through an initial public offering (IPO).

leveraged buyout (LBO) A single investor or group of investors buys, with the help of borrowed money (leveraged against the company's assets), the outstanding shares of a publicly traded company in order to take it private.

Private companies enjoy certain benefits that public companies do not. Private companies are not required to disclose financial statements. They experience less scrutiny from analysts and can often focus more on long-term viability. In 2013, computer maker Dell Inc. became a takeover target of famed corporate raider Carl Icahn.[34] He jumped into action after Dell's founder and its largest shareholder, Michael Dell, announced in January of that year that he intended a *leveraged buyout* with the help of Silverlake Partners, a private equity firm, to take the company private. In the Dell buyout battle, many observers, including Icahn who is the second-largest shareholder of Dell, saw the attempt by Michael Dell to take the company private as the "ultimate insider trade."

This view implied that Michael Dell, who is also CEO and chairman, had private information about the future value of the company and that his offer was too low. Dell Inc., which had $57 billion in revenues in its fiscal year 2013, has been struggling in the ongoing transition from personal computers such as desktops and laptops to mobile devices and services. Between December 2004 and February 2009, Dell (which until just a few years earlier was the number-one computer maker) lost more than 80 percent of its market capitalization, dropping from some $76 billion to a mere $14 billion. In late 2013, Dell's shareholders approved the founder's $25 billion offer to take the company private, thus avoiding a hostile takeover.

If a hostile takeover attempt is successful, however, the new owner frequently replaces the old management and board of directors in order to manage the company in a way that creates more value for shareholders. In some instances, the new owner will break up the company and sell its pieces. In either case, since a firm's existing executives face the threat of losing their jobs and their reputations if the firm sustains a competitive disadvantage, the market for corporate control is a credible governance mechanism.

To avoid being taken over against their consent, some firms put in place a **poison pill**. These are defensive provisions that kick in should a buyer reach a certain level of share ownership without top management approval. For example, a poison pill could allow existing shareholders to buy additional shares at a steep discount. Those additional shares would make any takeover attempt much more expensive and function as a deterrent. With the rise of actively involved institutional investors, poison pills have become rare because they retard an effective function of equity markets.

poison pill Defensive provisions to deter hostile takeovers by making the target firm less attractive.

Although poison pills are becoming rarer, the market for corporate control is alive and well, as shown in the battle over control of Dell Inc. or the hostile takeover of Cadbury by

Kraft (featured in Strategy Highlight 9.2). However, the market for corporate control is a last resort because it comes with significant transaction costs. To succeed in its hostile takeover bid, buyers generally pay a significant premium over the given share price. This often leads to overpaying for the acquisition and subsequent shareholder value destruction—the so-called *winner's curse.* The market for corporate control is useful, however, when internal corporate-governance mechanisms have not functioned effectively and the company is underperforming.

AUDITORS, GOVERNMENT REGULATORS, AND INDUSTRY ANALYSTS. Auditors, government regulators, and industry analysts serve as additional external-governance mechanisms. All public companies listed on the U.S. stock exchanges must file a number of financial statements with the *Securities and Exchange Commission (SEC),* a federal regulatory agency whose task it is to oversee stock trading and enforce federal securities laws. To avoid the misrepresentation of financial results, all public financial statements must follow *generally accepted accounting principles (GAAP)*[35] and be audited by certified public accountants.

As part of its disclosure policy, the SEC makes all financial reports filed by public companies available electronically via the EDGAR database.[36] This database contains more than 7 million financial statements, going back several years. Industry analysts scrutinize these reports in great detail, trying to identify any financial irregularities and assess firm performance. Given recent high-profile oversights in accounting scandals and fraud cases, the SEC has come under pressure to step up its monitoring and enforcement.

Industry analysts often base their buy, hold, or sell recommendations on financial statements filed with the SEC and business news published in *The Wall Street Journal, Bloomberg Businessweek, Fortune, Forbes,* and other business media such as CNBC. Researchers have questioned the independence of industry analysts and credit-rating agencies that evaluate companies (such as Fitch, Moody's, and Standard & Poor's),[37] because the investment banks and rating agencies frequently have lucrative business relationships with the companies they are supposed to evaluate, creating conflicts of interest. A study of over 8,000 analysts' ratings of corporate equity securities, for example, revealed that investment bankers rated their own clients more favorably.[38]

In addition, an industry has sprung up around assessing the effectiveness of corporate governance in individual firms. Research outfits such as GovernanceMetrics International (now GMI Ratings)[39] provide independent corporate governance ratings. The ratings from these external watchdog organizations inform a wide range of stakeholders, including investors, insurers, auditors, regulators, and others.

Corporate-governance mechanisms play an important part in aligning the interests of principals and agents. They enable closer monitoring and controlling, as well as provide incentives to align interests of principals and agents. Perhaps even more important are the "most internal of control mechanisms": *business ethics*—a topic we discuss next.

12.3 Strategy and Business Ethics

LO 12-6
Explain the relationship between strategy and business ethics.

business ethics
An agreed-upon code of conduct in business, based on societal norms.

Multiple, high-profile accounting scandals and the global financial crisis have placed business ethics center stage in the public eye. **Business ethics** are an agreed-upon code of conduct in business, based on societal norms. Business ethics lay the foundation and provide training for "behavior that is consistent with the principles, norms, and standards of business practice that have been agreed upon by society."[40] These principles, norms, and standards of business practice differ to some degree in different cultures around the globe. But a large number of research studies have found that some notions—such as fairness, honesty, and reciprocity—are universal norms.[41] As such, many of these values have been codified into law.

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Law and ethics, however, are not synonymous. This distinction is important and not always understood by the general public. Staying within the law is a *minimum acceptable standard.* A note of caution is therefore in order: A manager's actions can be completely legal, but ethically questionable. For example, consider the actions of mortgage-loan officers who—being incentivized by commissions—persuaded unsuspecting consumers to sign up for exotic mortgages, such as "option ARMs." These mortgages offer borrowers the choice to pay less than the required interest, which is then added to the principal while the interest rate can adjust upward. Such actions may be legal, but they are unethical, especially if there are indications that the borrower might be unable to repay the mortgage once the interest rate moves up.[42]

To go beyond the minimum acceptable standard codified in law, many organizations have explicit *codes of conduct.* These codes go above and beyond the law in detailing how the organization expects an employee to behave and to represent the company in business dealings. Codes of conduct allow an organization to overcome moral hazards and adverse selections as they attempt to resonate with employees' deeper values of justice, fairness, honesty, integrity, and reciprocity. Since business decisions are not made in a vacuum but are embedded within a societal context that expects ethical behavior, managers can improve their decision making by also considering:

- When facing an ethical dilemma, a manager can ask whether the intended course of action falls within the *acceptable norms of professional behavior* as outlined in the organization's code of conduct and defined by the profession at large.
- The manager should imagine whether he or she would feel *comfortable explaining and defending the decision in public.* How would the media report the business decision if it were to become public? How would the company's stakeholders feel about it?

Strategy Highlight 12.2 features Goldman Sachs, which has come under scrutiny and faced tough questions pertaining to its business dealings in the wake of the financial crisis.

In the aftermath of the Abacus debacle (discussed in Strategy Highlight 12.2), Goldman Sachs revised its code of conduct. A former Goldman Sachs employee, Greg Smith, published a book chronicling his career at the investment bank, from a lowly summer intern (in 2000) to head of Goldman Sachs' U.S. equity derivatives business in Europe, the Middle East, and Africa (in 2012).[43] Smith's thesis was that the entire ethical climate within Goldman Sachs changed over that period of time. For its first 130 years, Goldman Sachs was organized as a professional partnership, like most law firms. In this organizational form, a selected group of partners are joint owners and directors of the professional service firms. After years of superior performance, associates in the professional service firms may "make partner"—being promoted to joint owner. During the time when organized as a professional partnership, Goldman Sachs earned a reputation as the best investment bank in the world. It had the best people and put its clients' interests first. Smith describes how Goldman's culture—and with it, employee attitudes—changed after the firm went public (in 1999), from "we are here to serve our clients as honorable business partners, and we have our clients' best interests in mind," to "we [Goldman Sachs and our clients] are all grown-ups and just counter parties to any transaction."[44] In the latter perspective, unsuspecting clients in the Abacus deal were seen just as "counter parties to a transaction," who should have known better.

Some people believe that unethical behavior is limited to a few "bad apples" in organizations.[45] The assumption is that the vast majority of the population—and by extension, organizations—are good, and that we need only safeguard against abuses by a few bad

Strategy Highlight 12.2

Did Goldman Sachs and the "Fabulous Fab" Commit Securities Fraud?

In April 2010, the SEC sued Goldman Sachs and one of its employees, Fabrice Tourre, for securities fraud. The SEC's case focused on one specific, mortgage-related deal during the financial crisis. The deal began in 2006 during the height of the real estate bubble in the United States. The assumption at this time was that house prices could only go up, after years of consistent real estate appreciation. Indeed, real estate prices in the United States had surged, and a speculative bubble had emerged. The real estate bubble was fueled by cheap mortgages, many of them extended to home buyers who really couldn't afford them. John Paulson, founder of the hedge fund Paulson & Co., approached Goldman Sachs with a trading idea to place a billion-dollar bet that the real estate bubble was about to burst. This would occur when borrowers began to default on their mortgages in large numbers. House prices would collapse as distressed borrowers attempted to unload their properties at fire sale prices and banks foreclosed in large numbers. That is exactly what happened.

To benefit from his timely insight, Paulson asked Goldman Sachs to create an investment instrument, later named "Abacus." Goldman Sachs agreed and assigned Tourre to put Abacus together. This investment vehicle was a *collateralized debt obligation (CDO)*. CDOs are made up of thousands of mortgages bundled together into bonds. These bonds provide stable and regular interest payments as long as the borrowers make mortgage payments. CDOs were considered to be much safer investment choices than regular, standalone mortgages because defaults by a few borrowers would not matter much. To make matters worse, rating agencies such as Standard & Poor's, Fitch, and Moody's frequently rated such CDOs as "triple A," which is the highest-quality rating. A triple A rating indicates an "extremely strong capacity" for the borrower to meet its financial obligation. Only a few companies, such as Exxon, Johnson & Johnson, and Microsoft, hold a triple A rating. Given that the Abacus investment vehicle received a triple A rating, many institutional investors such as pension funds bought into it. Everything looked great: Abacus was offered by Goldman Sachs, the number-one investment bank in the world with a stellar reputation, and it had a triple A rating.

But, according to internal e-mails, Paulson and several Goldman Sachs employees, including Tourre, knew otherwise. For example, Tourre, who had earlier been dubbed "fabulous Fab," by a colleague, saw the nickname redound publicly to his discredit when it came out under oath. Specifically, one e-mail was from Tourre to his girlfriend at the time, in which he described himself wistfully in the third person, anticipating the burst of the real estate bubble:

> The entire building is at risk of collapse at any moment. Only potential survivor, the fabulous Fab (. . . even though there is nothing fabulous about me . . .) standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all the implications of these monstrosities.[46]

Paulson and Tourre worked together in selecting highly risky CDOs to roll into Abacus. Goldman Sachs then turned around and sold the Abacus CDOs to unsuspecting clients—without, of course, revealing the motivation behind Abacus. Nor did Goldman Sachs reveal that Paulson helped in selecting the riskiest CDOs to be bundled into Abacus. Paulson then took a "short position" in Abacus—meaning he actually bet against its success. Paulson & Co. sold shares that it did not yet own, in anticipation that the value would fall and Paulson would cover its sold shares by buying them at the fallen price. In contrast, institutional investors, often long-term Goldman clients, believed that Abacus was a great investment opportunity. When the real estate bubble burst, Paulson made more than $1 billion from his position in Abacus.

The question that immediately arose was whether Goldman Sachs defrauded investors—as the SEC believed. The SEC argued that the investment bank knowingly misled investors by not revealing its motives in putting Abacus together and not informing them about John Paulson's role in this transaction. Basically, the SEC alleged that Goldman violated its *fiduciary responsibility* and defrauded its clients. Mounting a strong legal defense, Goldman Sachs argued that it is up to the clients to assess the risks involved in any investments. As public pressure mounted, however, Goldman Sachs settled the lawsuit with the SEC by paying a $550 million fine without admitting any wrongdoing. Tourre declined a settlement, and his case went to court. In August 2013, Tourre was convicted of securities fraud.[47]

Tourre ultimately decided not to appeal the decision, stating instead he wished to complete his doctoral studies and hoped to make contributions to scholarship in the field of economics. He is currently pursuing a PhD at the University of Chicago.

actors. According to agency theory, it's the "bad agents" who act opportunistically, and principals need to be on guard against bad actors.

However, research indicates that it is not just the few "bad apples" but entire organizations that can create a climate in which unethical, even illegal behavior is tolerated.[48] While there clearly are some people with unethical or even criminal inclinations, in general one's ethical decision-making capacity depends very much on the organizational context. Research shows that if people work in organizations that expect and value ethical behavior, they are more likely to act ethically.[49] The opposite is also true. Enron's *stated* key values included respect and integrity, and its mission statement proclaimed that all business dealings should be open and fair.[50] Yet, the ethos at Enron was all about creating an inflated share price at any cost, and its employees observed and followed the behavior set by their leaders.

Sometimes, it's the bad barrel that can spoil the apples! This is precisely what Smith argues in regard to Goldman Sachs: The ethical climate had changed for the worse, so that seeing clients as mere "counter parties" to transactions made deals like Abacus possible. One could argue that Tourre simply followed the values held within Goldman Sachs ("profit is king" and "clients are grown-ups"). As a mid-level employee, many view Tourre as the scapegoat in the Abacus case.[51]

Employees take cues from their environment on how to act. Therefore, ethical leadership is critical, and strategic leaders set the tone for the ethical climate within an organization. This is one of the reasons the HP board removed then-CEO Mark Hurd (in 2010) even without proof of illegal behavior or violation of the company's sexual-harassment policy. The forced resignation was prompted by a lawsuit against Hurd by a former adult movie actress who worked for HP as independent contractor alleging sexual harassment. This action goes to show that CEOs of Fortune 500 companies are under constant public scrutiny and ought to adhere to the highest ethical standards. If they do not, they cannot rationally expect their employees to behave ethically. Unethical behavior can quickly destroy the reputation of a CEO, one of the most important assets he or she possesses.

To foster ethical behavior in employees, boards must be clear in their ethical expectations, and top management must create an organizational structure, culture, and control system that values and encourages desired behavior. Furthermore, a company's formal and informal cultures must be aligned, and executive behavior must be in sync with the formally stated vision and values. Employees will quickly see through any duplicity. Actions by executives speak louder than words in vision statements.

Other leading professions have accepted codes of conduct (e.g., the bar association in the practice of law and the Hippocratic oath in medicine); management has not.[52] Some argue that management needs an accepted code of conduct,[53] holding members to a high professional standard and imposing consequences for misconduct. Misconduct by an attorney, for example, can result in being disbarred and losing the right to practice law. Likewise, medical doctors can lose their professional accreditations if they engage in misconduct.

To anchor future managers in professional values and to move management closer to a truly professional status, a group of Harvard Business School students developed an MBA oath (see Exhibit 12.4).[54] Since 2009, over 6,000 MBA students from over 300 institutions around the world have taken this voluntary pledge. The oath explicitly recognizes the role of business in society and its responsibilities beyond shareholders. It also holds managers to a high ethical standard based on more or less universally accepted principles in order to "create value responsibly and ethically."[55] Having the highest personal integrity is of utmost importance to one's career. It takes decades to build a career, but sometimes just a few moments to destroy one. The voluntary MBA oath sets professional standards, but its effect on behavior is unknown, and it does not impose any consequences for misconduct.

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EXHIBIT 12.4 /

The MBA Oath

Source: www.mbaoath.org

As a business leader I recognize my role in society.

- *My purpose is to lead people and manage resources to create value that no single individual can create alone.*
- *My decisions affect the well-being of individuals inside and outside my enterprise, today and tomorrow.*

Therefore, I promise that:

- *I will manage my enterprise with loyalty and care, and will not advance my personal interests at the expense of my enterprise or society.*
- *I will understand and uphold, in letter and spirit, the laws and contracts governing my conduct and that of my enterprise.*
- *I will refrain from corruption, unfair competition, or business practices harmful to society.*
- *I will protect the human rights and dignity of all people affected by my enterprise, and I will oppose discrimination and exploitation.*
- *I will protect the right of future generations to advance their standard of living and enjoy a healthy planet.*
- *I will report the performance and risks of my enterprise accurately and honestly.*
- *I will invest in developing myself and others, helping the management profession continue to advance and create sustainable and inclusive prosperity.*

In exercising my professional duties according to these principles, I recognize that my behavior must set an example of integrity, eliciting trust and esteem from those I serve. I will remain accountable to my peers and to society for my actions and for upholding these standards.

This oath I make freely, and upon my honor.

12.4 ◀▶ Implications for the Strategist

An important implication for the strategist is the recognition that effective corporate governance and solid business ethics are critical to gaining and sustaining competitive advantage. Governance and ethics are closely intertwined in an intersection of setting the right organizational core values and then ensuring compliance.

A variety of corporate governance mechanisms can be effective in addressing the principal–agent problem. These mechanisms tend to focus on monitoring, controlling, and providing incentives, and they must be complemented by a strong code of conduct and strategic leaders who act with integrity. The strategist must help employees to "walk the talk"; leading by ethical example often has a stronger effect on employee behavior than words alone.

The strategist needs to look beyond shareholders and apply a stakeholder perspective to ensure long-term survival and success of the firm. A firm that does not respond to stakeholders beyond stockholders in a way that keeps them committed to its vision will not be successful. Stakeholders want fair treatment even if not all of their demands can be met. Fairness and transparency is critical to maintaining good relationships within the network of stakeholders the firm is embedded in. Finally, the large number of glaring ethical lapses over the last decade or so makes it clear that organizational core values and a code of conduct are key to the continued professionalization of management. Strategic leaders need to live organizational core values by example.

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CHAPTERCASE 12 / Consider This . . .

SOME CRITICS WOULD argue that Uber's motto seems to be "we don't care for any laws, rules, or regulations; we will deal with the legal fallout later, after we create a large number of happy users and drivers in a city that will support us and will lobby politicians on our behalf." Uber's customers are happy because they can hail rides conveniently and cheaply, often in areas that are underserved by regular taxis, and drivers are happy because they can choose when and how long to work.

Uber is also vehemently defending its policy of dynamic pricing. Without surge pricing, Uber emphasizes, taxis are simply not available during peak times because the limited supply is filled up so quickly. Surge pricing attracts more drivers on the road and helps in matching demand and supply. In further defense of its business model, it stated that the median income of an Uber driver in San Francisco is $75,000 while it is $91,000 in New York City. Meanwhile, Uber is investing heavily in the development of self-driving cars and more sophisticated online mapping systems. The goal appears to be to offer Uber rides by autonomous vehicles, replacing Uber's some 250,000 drivers, at some point in the future. Commenting on this strategic intent, CEO Travis Kalanick stated: "The reason Uber could be expensive is because you're not just paying for the car — you're paying for the other dude in the car. When there's no other dude in the car, the cost of taking an Uber anywhere becomes cheaper than owning a vehicle."[56] After an outcry by Uber drivers on social media such as Facebook and Twitter, Kalanick backpedaled by stating that he doesn't think autonomous cars will be ready for widespread use until 2035. In contrast, Google sees self-driving cars on the road as early as 2020.

Uber is also much more than a simple ride-hailing service. It is the greatest disruptor that the transportation industry has seen since the invention of the automobile. Uber is first disrupting old-line taxi and limo services, often protected by anticompetitive rules and regulations. But Uber also is disrupting transportation more generally. With a fleet of autonomous vehicles offering cheap rides, people don't need to own cars anymore. When car ownership is no longer needed, it will certainly impact the old-line car manufacturers. From there Uber might expand into the "delivery of everything," taking over last-mile deliveries for Amazon.com, Zappos, and other online retailers. Uber might even work in concert with shippers such as UPS and FedEx.

To improve public relations and to lobby politicians, Uber hired David Plouffe, whose claim to fame is being the manager for the 2008 Obama campaign and then a senior adviser to the president. Now senior vice president of policy and strategy at Uber, Plouffe sees Uber as an integral part of the transportation eco system. He argues that as more and more people live and work in cities, Uber will help to address traffic congestion, provide an alternative to personal cars in suburbs, cut down on drunk driving, and provide reliable and safe services to underserved city and suburban areas. Plouffe highlights that one of the reasons people remain trapped in poverty is the lack of reliable transportation, which Uber helps to overcome. Concludes Plouffe, "I don't subscribe to the idea that the company has an image problem. I actually think when you are a disrupter you are going to have a lot of people throwing arrows."[57]

Questions

1. Have you used a ride-hailing service such as Uber or Lyft? How was your experience?
2. Explain Uber's business model and deduce its strategic intent.
3. Do you agree with Peter Thiel's assessment that Uber is the "most ethically challenged company in Silicon Valley"? Why or why not? Explain.
4. Several lawsuits are under way to determine if Uber drivers are independent contractors or employees. The drivers bringing those lawsuits argue that they are employees and should be treated like employees, which would include being reimbursed for expenses such as gas and car maintenance that they currently pay out of pocket.
   - How do you view the so-called sharing economy with companies such as Uber, Airbnb (hospitality), TaskRabbit (house cleaning and odd jobs)?
   - What are the benefits and downsides of being an employee versus an independent contractor? Do you think drivers for Uber (and other ride-hailing services such as Lyft) are independent contractors or are employees?
   - If the ruling of California's labor commissioner should stand that Uber drivers are employees, and this view would prevail in the United States and other countries, what would this do to Uber's business model? Explain.

TAKE-AWAY CONCEPTS

In this final chapter, we looked at stakeholder strategy, corporate governance, business ethics, and strategic leadership, as summarized by the following learning objectives and related take-away concepts.

LO 12-1 / Describe the shared value creation framework and its relationship to competitive advantage.

- By focusing on financial performance, many companies have defined value creation too narrowly.
- Companies should instead focus on creating *shared value,* a concept that includes value creation for both shareholders and society.
- The shared value creation framework seeks to identify connections between economic and social needs, and then leverage them into competitive advantage.

LO 12-2 / Explain the role of corporate governance.

- Corporate governance involves mechanisms used to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.
- Corporate governance attempts to address the principal–agent problem, which describes any situation in which an agent performs activities on behalf of a principal.

LO 12-3 / Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.

- Agency theory views the firm as a nexus of legal contracts.
- The principal–agent problem concerns the relationship between owners (shareholders) and managers and also cascades down the organizational hierarchy.
- The risk of opportunism on behalf of agents is exacerbated by information asymmetry: Agents are generally better informed than the principals.
- Governance mechanisms are used to align incentives between principals and agents.
- Governance mechanisms need to be designed in such a fashion as to overcome two specific agency problems: adverse selection and moral hazard.

LO 12-4 / Evaluate the board of directors as the central governance mechanism for public stock companies.

- The shareholders are the legal owners of a publicly traded company and appoint a board of directors to represent their interests.
- The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO) and the oversight of the board of directors. The board of directors is composed of inside and outside directors, who are elected by the shareholders.
- Inside directors are generally part of the company's senior management team, such as the chief financial officer (CFO) and the chief operating officer (COO).
- Outside directors are not employees of the firm. They frequently are senior executives from other firms or full-time professionals who are appointed to a board and who serve on several boards simultaneously.

LO 12-5 / Evaluate other governance mechanisms.

- Other important corporate mechanisms are executive compensation, the market for corporate control, and financial statement auditors, government regulators, and industry analysts.
- Executive compensation has attracted significant attention in recent years. Two issues are at the forefront: (1) the absolute size of the CEO pay package compared with the pay of the average employee and (2) the relationship between firm performance and CEO pay.
- The board of directors and executive compensation are internal corporate-governance mechanisms. The market for corporate control is an important external corporate-governance mechanism. It consists of activist investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market.
- All public companies listed on the U.S. stock exchanges must file a number of financial statements with the Securities and Exchange Commission (SEC), a federal regulatory agency whose task it is to oversee stock trading and enforce federal securities laws. Auditors and industry analysts study these public financial statements carefully for clues of a firm's future valuations, financial irregularities, and strategy.

LO 12-6 / Explain the relationship between strategy and business ethics.

- The ethical pursuit of competitive advantage lays the foundation for long-term superior performance.
- Law and ethics are not synonymous; obeying the law is the minimum that society expects of a corporation and its managers.
- A manager's actions can be completely legal, but ethically questionable.
- Some argue that management needs an accepted code of conduct that holds members to a high professional standard and imposes consequences for misconduct.

KEY TERMS

Adverse selection *(p. 409)*
Agency theory *(p. 408)*
Board of directors *(p. 409)*
Business ethics *(p. 414)*
CEO/chairperson duality *(p. 411)*
Corporate governance *(p. 407)*
Inside directors *(p. 410)*
Leveraged buyout (LBO) *(p. 413)*
Moral hazard *(p. 409)*
Outside directors *(p. 410)*
Poison pill *(p. 413)*
Shared value creation framework *(p. 405)*
Shareholder capitalism *(p. 404)*
Stock options *(p. 412)*

DISCUSSION QUESTIONS

1. How can a top management team lower the chances that key managers will pursue their own self-interests at the expense of stockholders? At the expense of the employees? At the expense of other key stakeholders?
2. The Business Roundtable has recommended that the CEO should not also serve as the chairman of the board. Discuss the disadvantages for building a sustainable competitive advantage if the two positions are held by one person. What are the disadvantages for stakeholder management? Are there situations where it would be advantageous to have one person in both positions?
3. The shared value creation framework provides help in making connections between economic needs and social needs in a way that transforms into a business opportunity. Taking the role of consultant to Nike Inc., discuss how Nike might move beyond selling high-quality footwear and apparel and utilize its expertise to serve a social need. Give Nike some advice on actions the company could take in different geographic markets that would connect economic and social needs.

ETHICAL/SOCIAL ISSUES

1. Assume you work in the accounting department of a large software company. Toward the end of December, your supervisor tells you to change the dates on several executive stock option grants from March 15 to July 30. Why would she ask for this change? What should you do?
2. As noted in the chapter, the average compensation for a CEO of a Fortune 500 company was $14 million, and CEO pay was 300 times the average worker pay. This contrasts with historic values of between 25 and 40 times the average pay. In August 2015 the U.S. Securities and Exchange Commission (SEC) approved a rule mandating that U.S. firms publicly disclose the gap between their CEO annual compensation and the median pay of the firm's other employees.

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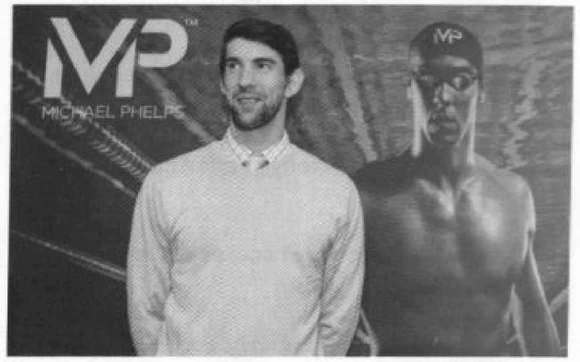
MiniCase 1

Michael Phelps: Strategy Formulation & Implementation

MICHAEL PHELPS, NICKNAMED MP, is the most decorated Olympian of all time. Competing in four Olympic Games,[1] the American swimmer won 22 Olympic medals, including 18 gold! In 2000 at the Sydney Olympics, Phelps at the age of 15 was the youngest U.S. athlete in almost seven decades. In 2008 at the Beijing Olympics, Phelps won an unprecedented eight gold medals, and while doing so set seven world records. Eight short days changed Olympic history and Phelps' life forever, making MP one of the greatest athletes of all time. Immediately after the event, *The Wall Street Journal* reported that Phelps would be likely to turn the eight gold medals into a cash-flow stream of more than $100 million through several product and service endorsements.



Michael Phelps, the most decorated Olympian
© DPA Picture Alliance/Alamy

Phelps did not rest on his laurels, however. In 2012 at the London Summer Olympics, Michael Phelps added another four gold and two silver medals, elevating him to superstardom. Phelps became an Olympic superhero against long odds. How was he so successful?

Strategy Formulation

In his youth, MP was diagnosed with attention deficit hyperactivity disorder (ADHD). Doctors prescribed swimming to help him release his energy. It worked! Between 2004 and 2008, Michael Phelps attended the University of Michigan, studying marketing and management. He had already competed quite successfully in the 2004 Athens Summer Olympics, where he won eight medals: six gold and two bronze. Right after the Athens Games, the then-19-year-old sat down with his manager, Peter Carlisle, and his longtime swim coach, Bob Bowman, to map out a detailed strategy for the next four years. The explicit goal was to win nothing less than a gold medal in each of the events in which he would compete in Beijing.

Bowman was responsible for getting MP into the necessary physical shape he needed for Beijing and nurturing the mental toughness required to break Mark Spitz's 36-year record of seven gold medals won in the 1972 Munich Olympic Games. Carlisle, meanwhile, conceived of a detailed strategy to launch MP as a world superstar during the Beijing Games. While MP spent six hours a day in the pool, Carlisle focused on exposing him to the Asian market, the largest consumer market in the world, with a special emphasis on the Chinese consumer. MP's wide-ranging presence in the real world was combined with a huge exposure in the virtual world. Phelps posts and maintains his own Facebook page, with 7.6 million "phans." MP is also a favorite of Twitter (1.6 million followers), YouTube, and online blogs, garnering worldwide exposure to an extent never before achieved by an Olympian. The gradual buildup of Phelps over a number of years enabled manager Carlisle to launch MP as a superstar right after he won his eighth gold medal at the Beijing Games. By then, MP had become a worldwide brand.

Frank T. Rothaermel prepared this MiniCase from public sources. This MiniCase is developed for the purpose of class discussion. It is not intended to be used for any kind of endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed, all errors and omissions are entirely the author's. Revised and updated: August 10, 2015. © Frank T. Rothaermel.

A successful strategy can be based on leveraging unique resources and capabilities. Accordingly, some suggest that MP's success can be explained by his unique physical endowments: his long thin torso, which reduces drag; his arm span of 6 feet 7 inches (204 cm), which is disproportionate to his 6-foot-4-inch (193 cm) height; his relatively short legs for a person of his height; and his size-14 feet, which work like flippers due to hypermobile ankles. While MP's physical attributes are a *necessary* condition for winning, they are *not sufficient*. Many other swimmers, like the Australian Ian Thorpe (who has size-17 feet) or the German "albatross" Michael Gross (with an arm span of 7 feet or 213 cm), also brought extraordinary resource endowments to the swim meet. Yet neither of them won eight gold medals in a single Olympics.

Strategy Implementation

Although Phelps was very disciplined in executing his meticulously formulated strategy to win Olympic gold medals, this is much less true for his strategy implementation to monetize his stardom outside the pool. Following the Beijing Olympics, a photo published by a British tabloid showed Phelps using a bong, a device for smoking marijuana, at a party in South Carolina. Kellogg's immediately withdrew Phelps' endorsement contract. After the London 2012 Olympics, Phelps (then 25) announced his retirement from swimming. After 20 months, he announced that he would come out of retirement. Just a few months later, however, in September 2014, Phelps was arrested for driving under the influence (DUI). In 2004, Phelps had also been arrested for DUI. After the second DUI arrest, Phelps received a one-year suspended jail sentence and 18 months of supervised probation. Phelps also spent 45 days in an in-patient rehab center for alcohol abuse in Arizona. USA Swimming, the national governance body, suspended Phelps for 6 months from all competitions and from representing the United States at the 2015 world championships.

In the spring of 2015, Michael Phelps announced his intention to compete at the 2016 Rio Olympics. Many experts predict that Phelps has a good chance of winning two more gold medals. What sponsors want to know, however, is whether the promised personal change is real, given that Phelps has made such promises before after his first DUI and then again when photographed smoking a marijuana pipe. Retaining a clean public image will also be critical for Phelps because he just launched his own line of swimwear MP, designed in collaboration with Aqua Sphere, a swimming equipment manufacturer. Phelps grew up idolizing Michael Jordan, and his goal is to change the public image and marketing of swimming to something akin to what Jordan accomplished with his Nike sponsorship in basketball.

DISCUSSION QUESTIONS

1. Olympians generally do not turn into global phenomena. One reason is that they are highlighted only every four years; e.g., not too many people follow competitive swimming or downhill skiing outside the Olympics. How did Michael Phelps (think Lindsey Vonn) turn into a global brand?
2. Which approach to the strategy process did Phelps, his coach, and manager use? Why was this approach successful?
3. Phelps was embroiled in a number of controversies outside the pool. What impact did these shortcomings have on his brand value? What do these incidents tell you about maintaining and increasing brand value over time?
4. What does Phelps need to do if he wants to play a similar transformative role in the marketing and sponsoring of swimming as Michael Jordan achieved in basketball?

Endnote

[1] Sydney in 2000; Athens in 2004; Beijing in 2008; and London in 2012.

Sources: This MiniCase is based on: "Michael Phelps confirms he's aiming to swim at 2016 Olympics," *The Baltimore Sun*, April 15, 2015; "Profile: Michael Phelps—A normal guy from another planet," *Telegraph*, August 15, 2008; "Now, Phelps chases gold on land," *The Wall Street Journal*, August 18, 2008; and "Michael Phelps' agent has been crafting the swimmer's image for years," Associated Press, September 14, 2008.