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Corporate governance reform

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Corporate governance reform: A social constructionist approach to recurring problems under agency theory's influence

Charl du Plessis

Abstract. A shift in the cultural conception of the firm as production-system to that as investment-system entrenches the institutional logic of agency theory in governance reform. Reform initiatives emphasise the separation between management and the board, forensic reporting requirements, and the primacy of shareholders' entitlement to control and residual gains. Problems associated with this agency logic render reform unable to deliver a broad-based ethical operating environment. The introduction of a version of stakeholder theory, augmented by Knightian uncertainty, places the development of an alternative conception of the firm into discourse. Implications for governance reform are considered.

Key words: Corporate governance, agency theory, stakeholder theory, ownership control, Knightian uncertainty, social construction, reform.

Introduction

There is a rich literature dealing with the nature of the corporation and the disputed scope of its legal and moral obligations. This discussion of corporate accountability contributes by supplementing the legal and moral approaches with a social constructionist approach to the questions of (1) to whom should the corporation be held accountable, and (2) for what should the corporation be held accountable. The first part of the paper offers a brief history of governance reform within a social constructionist framework (Zajac & Westphal, 2004) to illustrate through the US case how the interplay between theory, policy and practice, along with the struggle for control within the firm, had by the 1980s shifted the cultural conception of the firm as *production-system* towards that of the firm as an *investment-system* (Fligstein, 1990). The second part of the paper illustrates how this new cultural conception interacts with governance reform and how typical elements of an *agency logic* shaped the post-1980s direction of reform in the USA. The third section identifies problems associated with reform founded on the *agency logic's investment-*

system cultural mind-set, and claims that such reform initiatives will remain ineffectual in improving the ethical conduct of corporations. The fourth section places elements of an alternative cultural framework, generalisable beyond the US case, into dialogue. It augments a more discriminating account of stakeholder theory with Knightian uncertainty to propose a conception of the firm as a *co-evolutionary system of value-creation and uncertainty mitigation*. In conclusion, implications for governance practice are presented.

Evolvement of Governance and Shifting Cultural Conceptions of the Firm

From Managerialist to Agency Theory

The origin of the corporate governance debate is usually traced to the work of Berle and Means, who warned that management should be expected to serve as agents for themselves rather than for investors (1932). With the recognition that management may act in its own interest arose the need for proper oversight of management, steering them towards one objective – the delivery of value for shareholders. The role of the board of directors stems from this oversight duty – to represent the interest of the shareholders of the firm and to hold management to the objectives of the corporation.

Subsequently, several institutions in the US have either been particularly tasked, or have derived some authority to specify the conduct of both management and directors. The Federal Government can enact legislation, such as the Sarbanes-Oxley Act of 2002. At state level, which is the level at which incorporation takes place, common law plays an important role, and none as important as the precedent set by the courts of Delaware, where over 50% of Fortune 500 companies and those listed on the NYSE are incorporated (MacAvoy & Millstein, 2003). The New York Stock Exchange (NYSE) and NASDAQ set listing requirements, and do so under oversight from the Securities and Exchange Commission (SEC). Voluntary membership organisations like the National Association of Corporate Directors (NACD) and The Conference Board issue guidelines and research benchmarks for appropriate oversight measures.

The need for managerial oversight arose from a growing separation between the owners and managers of the firm with the rise of a professional class of

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managers. For the earlier part of the previous century, this separation was framed in Chandler's (1962) *managerialist* theory of the organisation. This framing, based on a so-called *corporate logic* (Zajac & Westphal, 2004), assumed managers to be professionals with the unique strategic knowledge required for the efficient allocation of corporate resources. As stewards of organisations with unique core competencies, professional managers had the primary responsibility for allocating resources, guided by their professional autonomy, and rewarded or punished for their performance by an efficient market for scarce managerial talent (ibid). However, MacAvoy and Millstein claim that as early as the 1940s and 1950s, it had become apparent that this market for control within the corporation functioned imperfectly. Mismanagement was not being punished as earlier assumed. The pre-1960s system of governance atrophied and between 1960-1990s the board became a mere support system for management. Management expanded their sphere of influence through investing funds in large diversifications, resulting in increased executive compensation and discretionary dividends. This phenomenon of managerial capitalism saw managers set their own agendas, bypass boards, and focus on employee problems, community enhancements, and other strategies aimed at perpetuating the corporation itself and the *loci* of managerial control and power. The growth in power and influence of management created a culture of impunity, as countervailing influences within the organisational structure were weakened relative to management. This imbalance created fertile ground for managerial greed to exploit opportunities for personal gain. CEOs now held the key to board seats and stock option pricing, which acted as further incentives for board members to collude, rather than to confront "imperial CEOs" (ibid.:1). Management's personal and corporate agendas came at the expense of efficiency gains that should have increased returns to investors (ibid.).

According to Zajac and Westphal (2004), researchers have documented how the prevailing beliefs and assumptions about corporate governance changed significantly towards an agency model of corporate control by the mid-1980s. They argue that this shift came about from a change in the fundamental assumptions about the purpose of governance and that it helped shaped normative beliefs across a wide range of business practices. As with every generation of governance reform dating back to the Great Depression and the post Great Depression birth of the SEC in the 1930s, the impetus for revisiting governance assumptions was provided by a series of scandals. The 1980s equivalent of the more recent Enron scandal was the Savings & Loans scandal, amidst mega-mergers enriching larger-than-

life CEOs and junk-bonds fueling hostile take-overs at a rate hitherto unknown. Citing Friedland and Alford (1991) and Scott (2001), Zajac and Westphal see this shift underpinned by changes in higher-order societal logic concerning economic activity. This new higher-order cultural frame, which until then supported the idea of the professional manager with autonomy, had by now adopted the logic of the capital market, and with that emerged a conception of the organisation based on agency theory (Jensen & Meckling, 1976), rather than on the *managerialist theory* (Chandler, 1962).

	Corporate Logic	Agency logic
Assumptions about:		
<i>Top Managers</i>	<ul style="list-style-type: none"> Professionals with unique strategic knowledge required for efficient allocation of corporate resources Stewards of their organisations 	<ul style="list-style-type: none"> Relatively fungible agents of shareholders Pursue strategies that advance personal interests at expense of shareholders
<i>The Firm</i>	<ul style="list-style-type: none"> An institution with unique core competencies Production-system (Fligstein) 	<ul style="list-style-type: none"> A nexus of contracts; a legal fiction Investment-system (Fligstein)
<i>Concept of Resource Allocation</i>	Managerial Capitalism: Top managers have primary responsibility for allocating resources to different businesses in the corporation	Investor Capitalism: Shareholders can diversify better and more easily than firms
<i>Links to high-order cultural frames</i>	Norm of professional autonomy	Logic of capitalist markets
<i>Links to theories of organisation</i>	Managerialist theory (Chandler)	Agency theory (Jensen and Meckling)
Implications for Governance Practices:		
<i>Compensation</i>	Salary and incentives are used to attract and retain scarce management talent	Use incentives to align management and shareholder interests, interpreted as profit only
<i>Allocation of Cash Flow</i>	Retain and reinvest	Redistribute to shareholders

Figure 1: Zajac and Westphal's Corporate vs. Agency Logic of Governance (Adapted)

Agency theory held that the firm was merely a nexus of contracts, with management being rather fungible and subject to the same market forces that MacAvoy and Millstein dispute. Furthermore, agency theory proposed that investors could diversify their own portfolios better than what the firm could achieve through structural diversification from mergers and acquisitions. This new framing impacted on specific governance practices. For example, a 1995 study by Zajac and Westphal of verbal explanations for executive incentive plans found that

whereas incentive plans for managers in the 1970s were typically justified as mechanisms to attract and retain scarce managerial talent, these same plans were justified by the mid-1980s as mechanisms for the alignment of managerial and shareholder interests (2004). This intended alignment would be consistent with an agency theory view of the organisation that emphasises a putative conflict between management and owners.

From Production-System to Investment-System

The social construction of the firm follows as much from the interplay between economic theory, policy and practice, as it does from the influence of the winners of the internal struggle for control within the firm. Hence, before reviewing the first wave of significant corporate governance reforms under the agency logic, one other phenomenon deserves attention – the changes in the role and importance of the Chief Financial Officer (CFO), as indicator of how proponents of an *investment-system* view won the struggle for internal control of the firm over the *production-system* view. Zorn describes the change in the prominence of the CFO as “a dramatic transformation of finance managers from bean counters to spin doctors” (2004:345). He studied a sample of 429 firms to show that the prevalence of the CFO position rose from a low of less than 10% of firms through much of the 1960s and 1970s that had a CFO, to approximately 80% of the sampled firms by 2000.

There are generally two primary explanations offered for why financial managers have been replacing the COO as the most important executive at the side of the CEO. Capital-dependency theory argues that the need that firms have for access to capital prompted the restructuring of the locus and nature of financial expertise within firms (Prechel, 1991 and 2000, in Zorn, 2004). The other explanation follows from Neil Fligstein’s theory of conceptions of control within the firm (1990). Fligstein posits that environmental changes such as new legislation, regulation or rules in response to scandals or shifting market conditions, trigger responses between management factions with different cultural conceptions of the firm. Those who entrench themselves at the top then bring their vision to bear on the firm’s strategic course. Whereas Fligstein distinguishes broadly between two different cultural visions of the firm, namely that of *production-function* and that of *investment-system*, the rise of the CFO to the top suggests that the cultural view of the firm as a system of investment won the contest for control. Zorn describes how Fligstein’s study overturned Chandler’s view (*The Visible Hand*, 1977) that efficiency concerns were responsible for the boom of CEOs from a finance background. Fligstein demonstrates that

players from the finance discipline came to power not because of some natural progression of the firm, but rather because this group of managers were able to convince corporate boards and shareholders that their management specialty held the key to better corporate results when faced with changing legislation (Zorn, 2004). Most significantly, a regulatory change from the SEC and FASB (Federal Accounting Standards Board) mandated replacement-cost accounting in the reporting of earnings, in response to high inflation in the preceding period. The result of the emergence of the financiers’ shareholder-value conception of the firm, according to Zorn, was that since the late 1980s, the management of stock price has been placed at the very center of corporate decision making (ibid.). With a wave of mergers erupting in the 1980s, coupled with the growing voice of institutional investors and of regulators’ response to scandals, the CFO became part of the first line of defense in identifying underperforming units, and in the managing of relations with shareholders, market expectations and the firm’s stock price. The CEO-CFO emerged as the “dynamic duo of the late 1980s and 1990s” (ibid:351).

Elements of the Agency Logic

It is against this backdrop of a shift of cultural conceptions away from the *firm as production-function*, based on the corporate logic, towards that of an *investment-system*, based on an *agency logic*, that one can make better sense of the motives and policies that have driven corporate governance reform since the 1980s. This shift, and therefore the agency logic, is typified in the corporate governance area by a variety of elements, some of which will be easier to recognise than others when one analyses the post-1980s reforms in the next section. The salient elements of the *agency logic* are that it:

- fixates on the conflict and divide between the owners and non-owning functionaries of the firm;
- promotes the idea that further separation between these parties may be useful in resolving the conflict between their respective interests;
- contends that the high cost of monitoring performance is both necessary and sufficient to contain aberrant behavior across the firm;
- considers profit-maximisation the sole interest of investors; and
- holds that stock ownership represents the riskiest engagement with the firm.

This list does not pretend to represent a complete view of agency theory itself. It is simply a summary of identifiable trends within governance reform through which the agency logic, the underpinnings of a cultural framework, manifests.

The Establishment of the Agency Logic's Dominance

Early Governance Reform

Towards the 1980s, the call for a return to the basic governance doctrine, whereby boards, as the agents of shareholders would monitor management performance and ensure a focus on total returns to shareholders, were spearheaded by two sets of actions in the USA. The first action was the active and public demand being made by institutional investors, such as public pension funds, for the board to hold management accountable for the outcome of mergers and on other performance metrics. The second action was the position taken by Chancellor William T. Allen, who presided over a series of well-publicised cases in the Delaware courts filed by shareholders against management and directors, and which set the tone for new standards of conduct for directors in the court's interpretation of its fiduciary duties (MacAvoy & Millstein, 2003).

The SEC responded with the requirement that boards form committees, composed wholly of independent directors, so designed to monitor compliance with SEC regulations on financial reporting. In 1977, the SEC approved the NYSE rule that all listed US companies form audit committees comprised of a majority of independent directors. Further signs of shareholders asserting their rights more aggressively came through the SEC requiring boards to pursue the interests of shareholders willing to sell when management resisted take-over, and the SEC also changed the proxy rules for voting shares that now made it possible for shareholders to band together and publicise their voting positions against a management initiative. After General Motors (GM) fired a non-performing CEO in 1992, the GM board published its governance guidelines, which prompted one of the largest institutional investors, CalPERS, to pressure its entire portfolio of companies into introducing these guidelines. The GM guidelines became the *de facto* standard for board independence, and it signaled a clear shift towards board professionalism. In future, boards would take on more responsibility for the formulation of corporate strategy.

During this period, hope emerged that the increased ease with which shareholders could communicate through the Internet offered the potential to mitigate the essential coordination problem faced by dispersed shareholders seeking a unified voice. However, the rulemaking authorities were less reluctant to allow the potential democratisation of the governance process. The only sign of any movement in the direction of shareholder nomination of directors came in a June 2003 SEC *Division of Corporate Finance Staff Report*. This report proposed that shareholders who

collectively own 5% or more of common stock be permitted to introduce candidates in the following ratio: 1 candidate if the board has 8 or less directors, 2 candidates for boards of 9 – 19 members, and 3 candidates for a board of 20 or more members. This permission would remain subject to further triggering events, e.g., the prior rejection of a management candidate by 35% or more of shareholders, or the petition for direct nomination by at least 1% of shareholders gains majority approval at a prior shareholder meeting (Fisch & Gentile, 2003). This proposal represented an almost insurmountable procedural hurdle, and even when eventually overcome, its effect would be delayed for so long that it would be virtually toothless. Despite the advent of the potential for easier and cheaper communication between dispersed shareholders, their coordination problem remained unresolved because of the lack of corresponding procedural rights.

So stood governance reform by the end of the 1990s. Steeped in the *agency logic*, reformers advocated a deepening distance between management and the board, giving the relationship more an air of forensic adversity than of strategic partnering. As recent history has shown, these earlier reforms proved to be rather ineffectual in stemming the tide of corporate transgressions easiest referred to as “the Enron-era,” and shortly after the turn of the 20th century, another round of initiatives appeared on the governance landscape. The last part of this section introduces the most progressive reform proposals, as advocated by MacAvoy and Millstein, and assesses them in conjunction with other recent reform initiatives.

Current and Future Direction of Governance Reform

One of the most progressive sets of reform proposals are advanced by two leading scholars of corporate governance, Paul MacAvoy and Ira Millstein (2003). They advocate:

- The complete separation of the roles of Chair and CEO, and the designation of an independent director as Chair;
- The extension of the financial certification requirements by CEOs and CFOs to the board;
- Boards taking on the responsibility for company strategy, risk management and financial reporting; and
- Board assurance of the integrity of management.

The authors argue that governance reforms during the 1990s, as well as during the latest round of adjustments focused mostly on “board structure and disclosure,” while the real need for change is “board conduct” (ibid: 98). In their view, mere structural change does not generate an active and independent board, and although they acknowledge that “conduct is too

ephemeral for detailed legislation," they see true independence as the best guarantee for the change in conduct demanded by the scale of the problem (ibid: 99). They also argue that the board should have the right to retain its own advisors, consultants and counsel as they deem necessary to carry out their duties (ibid). How do their proposals fit with other reform initiatives?

The most visible reform took place at Federal level, with Congress passing the Sarbanes-Oxley Act of 2002. This act sticks closely to the *agency logic* with emphasis on reporting and accounting measures. However, it does not extend the certification of annual and quarterly reports to the board of directors, as proposed by MacAvoy and Millstein, who argue that if board members do not avail themselves of the information systems and methods by which certifying CEOs and CFOs prepared financial reports, how could they judge such reports' accuracy? (ibid).

The NYSE and NASDAQ have proposed significant amendments to their corporate governance listing requirements. These proposals would require boards to be comprised of a majority of independent directors, with a tighter standard of what constitutes independence. The responsibility of independent directors on standing groups like auditing, compensation, and (often newly minted) nomination/governance committees must expand, and directors must meet in regularly convened executive sessions restricted to non-executive directors. A presiding director leads these sessions. Lastly, the board must perform regular board and committee evaluations, and publish company-specific governance guidelines and codes of conduct and ethics. MacAvoy and Millstein's proposals embody much of the same spirit, but their insistence on the appointment of an independent Chair would make exchange proposal references to "presiding" or "lead directors" redundant.

The Conference Board's Commission on Public Trust and Enterprise, generally considered US industry's best practices benchmark, proposes careful consideration of the separation of the positions of Chair and CEO, yet sketches different scenarios where less than perfect separation may be possible. The commission suggests that companies who fail to establish complete separation should explain both their reason for not following the guideline, as well as specify how they will pursue the objectives of a strong, independent board. Furthermore, the commission set out guidelines for director qualifications, the role of the nomination/governance committee in bringing the right people together, and developing a process by which to evaluate its own performance. Ethical behavior is made the responsibility of the board, with a variety of structural proposals about how the board must "set the tone at the top" (Conference Board, 2003:2-28). There is a

measurable degree of difference between the position of this commission and the progressive position MacAvoy and Millstein take.

The one institution which varies from other reform proposals and that takes the same tack as MacAvoy and Millstein's in emphasising *conduct* over *structure* is the court in Delaware. From mid-2002 to early 2003, the Delaware Supreme Court issued written decisions in five cases where it held in favor of shareholders and against directors, thereby reversing Court of Chancery decisions that had earlier rejected shareholder claims. The failure of Sarbanes-Oxley and the exchanges to provide for private, rather than criminal enforcement by the SEC or Federal authorities means that the state court is the only forum where private actions against directors can and will be pursued. Private actions may rely on the new reforms in several ways to ask the court to set a new standard for director conduct. Traditionally, fiduciary duties required directors to act with *loyalty*, *due care*, *good faith*, and the *honest belief that they are acting in the best interests of the corporation*. The business judgment rule is based on these concepts, and until now, the presumption that directors make decisions independently, with due care and in good faith, made the courts reluctant to second guess the actions of directors. The good faith provision may however be expanded in the future, meaning whereas in the past it only prohibited self-dealing, self-interest, or serving any interest except that of the corporation and shareholders, it may now require directors to avoid reckless, irresponsible or irrational conduct, using the standards set by the new reforms to determine the appropriate measure of diligence.

This trend has huge ramifications for life in the boardroom. The higher likelihood of incurring liability as a director may shape conduct in one of two ways: directors might resign believing that their compensation no longer matches the risk of liability; or the board may change its conduct in line with the MacAvoy and Millstein proposals, i.e., asserting itself in the affairs of the corporation, and gathering and analysing information with its own staff and advisors in order to set an independent agenda for the oversight of corporate and management performance.

The thinking behind historic and new reform, as well as the more progressive MacAvoy and Millstein exponent thereof, illustrate the recurring presence of typical elements of the *agency logic*. Reform initiatives propose ever more board independence, and increased and costly control and oversight of management – reinforcing the assumptions and solutions of *agency* theorists. Furthermore, the motive behind these reform initiatives is the protection of the profit-maximising interest of shareholders, a protection they are deemed entitled to by virtue of their ownership of the firm. In the next section, several problems associated with the *agency logic* are

brought to the fore, to suggest that the current trend in reform is not only ineffectual in addressing broader ethical concerns, but that it is incapable of resolving even the narrow principal-agent problem.

Problems Associated with Reform Driven by the Agency Logic

Governance reform is accountable for the smooth oversight of management by a board of directors, but must also be able to account for the creation of a set of relationships, objectives, systems, structures, incentives and rewards that ensure ethical conduct across the complete scope of the firm's activities. We will hold current governance reform initiatives and its underlying logic to that standard. In this section, specific problems within the field of governance that emerge from the *agency logic* are raised. It is argued that the existence of these problematic conditions will continue to render governance reform as ineffectual as it was during the 1990s, and will make it impossible to attain the desired standard.

The Undesirability of Separation

The first critique of the *agency logic* is leveled against its tendency towards centralisation of decision-making power, most explicitly seen in MacAvoy and Millstein's proposal to assign strategic responsibility to the board. This trend towards centralisation works in the opposite direction of management practice, where devolution of decision-making power and the empowerment of lower-level managers and employees have become common cause. Agency theory assumes management to be fungible "drones," i.e. lacking the unique qualities that constitute good leadership (Carl Icahn, in Zajac & Westphal, 2004:436). However, there is a plurality of motives and talents amongst corporate executives, and the *agency logic* gives short shrift to the majority of CEOs who do an earnest job in leading their companies on a straight, narrow and efficient path.

A more accurate assignment of decision-making power should recognise the important manner in which executive leadership shapes the values of the firm and its employees, while still recognising the need for proper accounting and oversight. Given the relationship between ethical conduct and decision-making power, a move towards centralisation lessens the opportunity to address firm-wide ethical practice, while upping the ante on the policing of employees. The centralisation problem undermines the enterprise in at least three ways: It limits the distribution of information, it dilutes managerial motivation, and it sidelines relationships of trust. Given the importance of information about the firm's activities and

opportunities in setting strategy, the migration of decision-making power one level further away from the coal face (from the CEO to the board) creates additional complexity in bringing appropriate information to bear on critical decisions. The stripping of the CEO of important decision-making power is counter-productive to managerial motivation and may render lame-duck leadership that could cascade down the organisation. Carl Icahn's cruel description of management as "drones" may become a self-fulfilling prophecy. Enough has been written to demonstrate the importance of leadership in setting the moral tone and example for the rest of the organisation. Lastly, the important checks and balances on ethical behavior that come from the relationships of trust developed between management, employees and other key stakeholders may get lost when functionaries are stripped of their sense of ownership in the management process.

The Improbability of Separation

The agency logic sets management up in an opposing camp to shareholders and their boards and then seeks to keep them apart as a way of ensuring ethical conduct. It is telling that several of the corporations currently in the dock already met the test for independent boards. For example, the board of Enron, which shortly before its collapse was ironically ranked by *Chief Executive* magazine as having one of the five best boards in 2000 included several reputable and seasoned non-executive directors, including the dean emeritus of the Stanford Business School and a former accounting professor. Likewise, WorldCom's board included multiple experienced outside directors, amongst others a former head of the National Association of Securities Dealers and the dean of the Georgetown University Law Center (Schwartz, Dunfee & Kline, 2005). The proposed shift towards the independence of directors escalates many of the same perceived problems of agency previously experienced at executive level to the level of the board. A theory that sets parties up in opposite camps to police one another will eventually run out of players who can oversee those who have to oversee the ones who are overseeing. All that would remain would be the governance dead-end of handing the management of the company back to its shareholders, which would severely limit corporations' potential scale, increase transaction cost, and reduce transparency when companies exit the listed environment (See Figure 2). It should be noted however, that not all private owners manage their own companies, as some retain professional management. Therefore, even taking a company private would not necessarily solve the agency problem. The mistake that MacAvoy and

Millstein, and to a lesser degree other reformers make, is to see separation as metaphor for independent conduct. True independence is hardly possible, a position argued by Reiter and Williams when they assessed the metaphoric content of the concept of independence in their review of the problems experienced by the accounting profession in establishing standards of independence (2004). They cite Siegel and McGrath's (2003) discussion of five generic threats to independence (Reiter and Williams, 2004). These are self-interested threats, self-review threats, advocacy threats, and psychological threats of familiarity, intimidation, and cognitive biases such as self-serving bias, confirmation bias, anchoring, optimism, overconfidence and recency effects (ibid.). The content of these threats is better explained by the original authors, yet what can be condensed here is that when directors and managers all come from a rather homogeneous cultural set and power-group, and rely on each other for their appointments, nominations and compensation, a sufficient level of independence that counters all these threats could hardly be attained.

The Impoverishment of the Concept of Value

One important consequence of the cultural conception of the firm as *investment-system* is the effect it has had on the concept of value. When corporations are held accountable, the prevailing idea is that they are foremost required to maximise shareholder value, i.e., profit maximisation. The assumption that shareholders value profit only is ever-present in our management literature and in common law. However, shareholders are not abstracted wallets – they are members of the same communities whose life plans are subject to the same intended and unintended consequences of the activities of public commercial entities.

In *On Ethics and Economics*, Amartya Sen elaborates on earlier critiques, most notably by Herbert Simon, against the prevailing approach in neo-classical economics to simplify human behavior to the point of one assumption, namely rational self-interest, or in its economic variant, profit-maximisation (1987). The real issue to him is whether there may not be a plurality of motivations that drives human beings (ibid). Sen counters the rationality assumption by arguing that we all often make mistakes, that we all experiment, and that we sometimes get confused. As Sen puts it: "The coolly rational types may fill our textbooks, but the world is richer" (ibid: 11). The pillars of the rationality assumption are that firstly, rationality demonstrates internal *consistency* of choice, and secondly, it always entails *maximisation of self-interest*. Sen counters that neither of these

mainstays is consistently true for all human behavior, arguing for a pluralistic and richer nature of human behavioral motivation.

Regarding the *consistency* requirement, Sen holds that our preferences change over time, or that there are times when we do not necessarily know what we prefer. The flux that he alludes to could be the result of changes in the bounds of our information, disregarded by the agency theorists' assumption of perfectly competitive markets amidst perfect information. It could also be the result of emotional shifts, a condition relegated by the market and the nation-state to the private sphere and hence held to be of no consequence to the conception of rationality (Berezin, 2002). Philosopher William James held that rationality was a sentiment or an emotion and that all humans need a sense of a relation of a thing to its future consequences (1956). According to Berezin, this points to a relation between trust, risk and emotion. Without the threat of de-stabilisation, emotion lies dormant (2002). Given that the reward from corporate activity is intimately tied to the willingness to expose oneself to de-stabilising events, a definition of rationality sans emotion seems empty. And when we open the door for emotion, we open the door for changes in behavior and preference, as the relationship between humans and the future and their trust in possible outcomes takes on a perpetual flux.

On the *self-interest maximisation* requirement, Sen's position could not be made clearer than when he states that "universal selfishness as actuality may well be false, but universal selfishness as a requirement of rationality is patently absurd" (1987,16). He argues that there may be times when our commitment to certain individuals, groups or ideas may result in placing our own interests secondary to the commitment. An interesting recent challenge to Jensen's insistence on this single dimensional objective of profit maximisation is offered by Hsieh (2005), whose commentary could be paraphrased as not necessary thinking of maximisation as "more of the same," but possibly also as "the best combination of several." Under this conception, it seems possible for an investor to rationally consider multiple interests along with profit when deciding which combination best represents his or her preferences.

The plurality of values that Sen and Hsieh advocate is already part of the managerial landscape. For example, a strong institutional investor such as CalPERS functions under dual objectives – seeking financial returns for its members, but also raises its voice when management action in the pursuit of this objective may threaten the livelihood of its pension fund members, an alternate objective. And Merck's shareholders live comfortably with the decision to donate large quantities of drugs for HIV/AIDS or river blindness.

Further support for an argument in defense of more textured investor sentiments comes from the growing number of firms adopting so-called “triple bottom-line” reporting, where additional account is given of the firm’s performance in the social and the environmental spheres. Even though the normative case for such reporting may not yet have been made conclusively, there seems to be important enough strategic reasons for several firms to adopt these measures. The *2003 Report on Socially Responsible Investing Trends in the United States*, published by the Social Investment Forum, indicates that by 2001, investment under SRI management has grown to \$2,32 trillion, and proponents of SRI point to this figure to argue that such investor sentiments have become a market force that can no longer be ignored (Lydenburg, 2005). This trend explicitly illustrates that investors have concerns and interests in areas other than profit alone.

The *agency logic’s* insistence on a grossly oversimplified version of investor sentiment entrenches the view of the firm as *investment-system*. There is no doubt that investors first and foremost want to tend to their security and financial well-being, and hence expect proper returns on their investment. Yet, the *agency logic* framework does not know how to assign positive weight to values other than profit-maximisation. We have lost the language with which to bring these values to the fore and only become aware of how important they are to the investing public once they raise their sharp heads during criminal or ethical lapses and investors exercise their only sanction – exit! Simplified assumptions about human motivation may make some economic models work better, but we are at risk when we start believing that the results from these simplified approaches present the only accurate picture of the world we live in, and then develop our ideology, cultural conceptions, and institutional logic on these poor foundations.

By making profit-maximisation both the central and exclusive objective of the firm, the governance debate effectively closes the door on a richer discourse about accountability which may yield solutions to the unethical conduct that governance aims to curtail.

The Prioritisation of Ownership

A key element of our understanding of investment is the relationship between risk and reward, and hence the entitlement of shareholders as owners to determine the direction of the firm and for claims against residual income. The *agency logic* holds this dominance by owners and the protection of their interests as axiomatic.

However, today’s investor hardly faces the nerve-wrecking choice of pouring nuggets into an exploratory

passage to the New World. Diversification strategies abound and stock transactions are executed on short notice and around the clock. Owning stock is quite likely the least credible commitment to the firm and to the risk and uncertainty associated with its operation. Risk to stockholders exists only in the aggregate, i.e., should all stock owners decide to bail at the same time. On the other hand, in an era of high labor specialisation (social assets) and technical asset specificity, the credible commitments that stakeholders such as employees or suppliers make tie their fate closer to that of the firm than what is the case with contributors of that most fungible of commodities – money.

One argument proffered to explain why even amidst such mobility investors deserve the residual risk premium is that they may not be privy to information required to make an exit decision. This is a fair depiction of the investors’ position, yet once again, it is suggested that these investors are at no more of a disadvantage in the informational stakes than a lower-level employee or than a supplier facing competitive replacement after investment in specific assets.

This paper therefore argues that doubt could be raised whether the ownership of stock is particularly risky, or when understood to be risky, whether it is any riskier than the position of several other stakeholders. The critical question that this argument drives at is whether shareholders’ perceived risk warrants superior claims against the residual income of the firm, and warrants the authority to direct the firm for their exclusive benefit.

The *agency logic* supports this paramount claim of investors, as its key construct of the firm is that of an investment system. By supporting the exclusive entitlement claimed by investors, the divide between owners and non-owners introduced by Berle and Means is consistently reaffirmed in governance reform initiatives. This divide shuts out the possibility of a fruitful discourse with other stakeholders, which results in strategic opportunities getting lost, as well as increasing the incentive to capitalise at the expense of shareholders – the source of many of the ethical problems governance seeks to rectify. The firm as *an investment system* overlooks the co-evolution of the skills, know-how, investment, relationships, and commitment of suppliers, employees, customers and others amidst an ever-changing business environment.

A Viable Alternative to the Agency Logic?

It has been argued that governance reform resting on the institutional logic of agency theory and its cultural perception of the firm as investment-system will remain ineffectual in stemming unethical behavior.

The reform initiatives we have discussed entrench, rather than solve the problems associated with the agency logic. Having already shifted beyond the earlier corporate logic with its own management excesses, can any alternative conceptual framework be developed to reframe the governance conundrum? Cultural perceptions are not born overnight and a multitude of events, some major and some almost insignificant, driven by the interplay between theory, policy, and practice act together to shape new social constructs. It would therefore seem prudent at this point to attempt no more than placing preliminary thoughts about alternatives into dialogue.

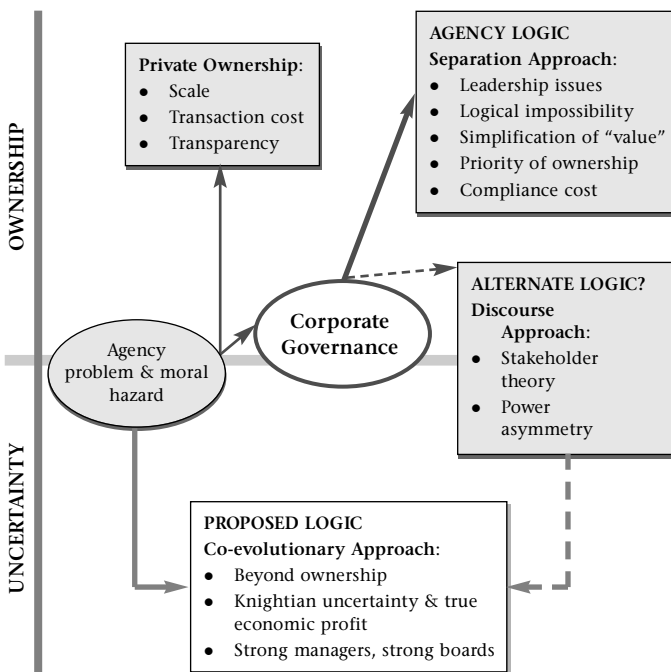


Figure 2: Developing an Alternative Approach to Corporate Governance

Given the centrality of an explanatory theory to the development of an eventual cultural framework, the appropriate starting point is the clarification of the objective of governance reform, and the presentation and evaluation of alternative theories for their ability to deliver on this objective. To be very clear, governance reform within itself is not particularly interesting. The real objective of reform is to try and force some larger measure of authentic independence in the oversight function of directors and to prompt more genuine dialogue as a way of curtailing inefficient and unethical conduct across the complete scope of corporate action and consequence. The Conference Board's Commission on Public Trust and Enterprise has it right when stressing that the tone for conduct is set at the top. The boardroom is the space where shareholders' intentions and employees' ideas reach confluence, and the decisions made in this arena impact directly on the decisions, conduct and performance of parties down to each employee or supplier. Therefore, reform initiatives

should not shirk from considering conduct beyond the management-board relationship alone. That ought to be the goal when searching for alternatives to the current governance regime – setting up an approach that reintegrates and makes governance central to the broadest possible discussion of ethics in the commercial sphere.

Stakeholder Theory, Discourse Ethics and Power

Freeman defined stakeholders in an organisation as “any group or individual who can affect or is affected by the achievement of the organisation's objectives” (1984). The immediate appeal of stakeholder theory is its emphasis on a more inclusive discourse about the firm, because at least two of the problems identified with the *agency logic* can immediately be addressed through discourse. Firstly, it offers one approach to working around problems associated with the prominence of ownership and shareholder rights when it proposes a more expansive discourse with other players in the firm's network. Secondly, the total interest of minority shareholders, and the non-monetary interest of strong shareholders are currently ignored in discourse about the firm. The stakeholder model advocates a model of engagement which can enrich this discussion about plural values. Both these arguments rest on normative claims, and it is a normative version of stakeholder theory that is presented here as the potential foundational theory for a new cultural framing.

The normative claim of non-owning stakeholders rests on the firm's duty to take responsibility for the intended and unintended consequences of its actions. This duty is often disputed, yet its strategic implications may shape corporate conduct in such a manner that we can afford leaving the issue unsettled for now. The normative claim of minority shareholders rests on an *equal right to participate* in the governance process, a right which is implicit to their *equitable right* to vote their share. (Equity is an inequality based on an agreeable metric, such as shareholder voting rights based on the number of shares held. Equality means “without inequality,” such as the equal right to participate in the voting process as shareholder, independent of whether you hold 100 or 10,000 shares). Although the right to participate exists formally, it is substantively void, as the running battles over proxy processes and the nomination of alternate directors demonstrate. The same argument could be made for the right of stronger shareholders to voice non-monetary sentiments.

One troubling aspect of stakeholder theory and its leading advocates is that they retain a firm-centric view, as would any organisational theory, and deliberately argue against extending the theory from its organisational scope to a broader politico-economic institutional discussion (*cf.* Phillips, 2003). So, although

stakeholder theory does locate the firm within a nexus of parties, and hence opens the door for interaction through discourse, it decidedly retains the right of the firm to drive this initiative and set the agenda. A brief consideration of the feminist critique against Habermas' (1962) discourse ethics halts the optimism that a firm-centric view with asymmetry in power relationships between owners and other stakeholders may move us towards a richer understanding of value-creation and dissemination through discourse between stakeholders (Fraser, 1990). Fraser attacks the assumption made by Habermas that interlocutors can bracket status differentials and can deliberate "as if" they were social equals" (ibid:62). As long as the firm-centric version of stakeholder theory tilts the power scale in favor of shareholders, it remains possible that this theory actually entrenches the centrality of ownership within the *agency logic* that lies at the heart of moral hazard and its problematic separation approach. This raises the question whether there is a better way of determining participation in the discourse over corporate decisions than what ownership rights offer?

From Ownership to Knightian Uncertainty

George Stigler, in a 1971 foreword to a reprint of Frank Knight's enquiry into the relationship between profit, risk, and the true determinant of pure economic profit, namely *uncertainty*, calls Knight's insights a "condensed restatement of the theory of value, which is the central part of economic theory." To find an alternative to the deeply entrenched *agency logic*, one may have to dig deep into the fundamentals, and Knight's work has occupied such space with respectability since first published in 1921.

Knight argued that there is an important difference between measurable uncertainty – "risk proper" – and unmeasurable uncertainty, and that the former is hardly an uncertainty, as probabilistic methods may be deployed to hedge against such risk. In his view, it is the "true uncertainty," that which cannot be measured, that forms the basis of a valid theory of profit (1921: 20). Knight proposes several methods with which to navigate uncertainty, of which consolidation (e.g., insurance or diversification) and specialisation (i.e., maintaining a competitive advantage in information) are two important strategies. Of more interest to our governance discussion are Knight's introduction of *control of the future and an increased power of prediction* (ibid).

Uncertainty not only connotes the negative role that we tend to assign to it. Uncertainty has two faces, of which the positive ability to create economic opportunity and stimulate progress was brought to the fore by Knight. This point is easiest understood in the dramatic, Schumpeterian creative destructive mode, where for example, a product development

team's launch of the Microsoft operating system created huge uncertainty to the industry and to users alike, yet over time managed to make its owner the richest man in the world. Nevertheless, the same principle applies to thousands of little acts that collectively may have the same positive effect. In this sense, we witness how Knight's method of navigating uncertainty as potential source of control over the future comes into play. The relevance to our governance discussion is that there is huge value in the early detection and engagement of stakeholders that may assist the firm in creating value through this kind of positive uncertainty.

Uncertainty in its usual drab guise could have the reverse effect on the firm's fortunes, and Knight's second method, namely developing an increased power of prediction is one way of guarding against unwelcome surprise. Once again, an expansive discourse that identifies and engages stakeholders that may help mitigate this kind of uncertainty for the firm through credible commitment and other mechanisms seems advisable.

In the earlier comparison of the commitment and informational differentials between mobile owners of shares and other stakeholders, it was argued that owning shares may be the least credible commitment to the firm's fortunes. If true value for the firm may best be achieved by engaging parties that can assist in creating positive uncertainty and mitigating negative uncertainty, this relationship with uncertainty offers a far more relevant reason for being included at par in the discourse over the firm's future than relying on the archaic notion of shareholding ownership. From the firm's perspective, one may argue that the hit-and-run potential of shareholders may itself constitute a different kind of moral hazard.

In summary, it appears fruitful to develop an alternative framework for corporate governance on the foundations of normative, stakeholder theory and Knightian uncertainty. Stakeholder theory for its emphasis on discourse, and Knightian uncertainty for its ability to augment the one shortcoming of stakeholder theory, namely the power differential between owners and other stakeholders, through recognising that uncertainty plays a more pertinent role than ownership in value creation and dissemination. From this discussion, one may want to think about replacing the cultural conception of the firm as an *investment-system* with that of the firm as a *co-evolutionary system of value creation and uncertainty mitigation*.

Implications

The Conference Board's Commission on Public Trust and Enterprise states that the ethical tone of the firm should be set at the top. Likewise, MacAvoy and

Millstein hold that the boardroom is the appropriate place for an in-depth discussion about the firm. I have stated that decisions made in the boardroom result in relationships, objectives, structures, systems, incentives and rewards that shape decisions and conduct right through the firm and the networks where the firm operates. Therefore, it was argued that the only manner in which governance reform can achieve its objective of broad-based ethical and efficient conduct would be to remove problems associated with an entrenched *agency logic* that hamper, rather than aid the reform process. When replacing the conception of the firm as *investment-system* with that of the firm as *co-evolutionary system of value-creation and uncertainty mitigation*, the co-evolutionary element of this conception demands stepping away from the divisive nature of the agency logic's separation and monitoring approach, in favor of an expanded discourse between mutually interested parties. Possible effects of this approach are:

- *Strong managers and professional boards*: Almost every influential reformer stresses the importance of strong corporate leadership in setting the moral tone of the firm. However, the separation trend of the *agency logic* offers an untenable either/or choice – reform must either opt for strong management and a weak board, or alternatively, for weak management under a strong board. By breaking with the *agency logic*, we can give substance to the MacAvoy and Millstein advocacy for a strong board, without undermining the authority and influence of management. This requires understanding that the reformers' intention behind the use of the term "professional directors" connotes specific functional skills and expertise. Despite the formidable talents, reputation, and dedication of many directors, the necessary functional skills for being the desired kind of director may be in short supply in the boardroom. A successful career as an executive is not an automatic preparation for a career as successful director, and the likes of a Hatchet Harry, Chainsaw Al, or of less sanguine executives might be limited in what they can offer in this very different functional capacity. To be more specific about the crucial functional requirements of a director: its an advisory role, requires industry knowledge, demands sympathetic engagement with management, shareholders and other stakeholders, expects meticulous attention to detail and financial information, and more. It is suggested that advisory status does not sit well with past executives who were used to taking charge, and also that they may be more used to passing down some of the nitty-gritty analytical work to subordinates. If the role of the board is to solicit and filter investors' and other stakeholders

expectations through to management, to advise and support management in the execution, and to oversee and provide feedback on performance, the job requirement may be more time-consuming, and very dependent of the different functional skills raised above. A seat on the board should not be the reward for an illustrious career as executive (stock options seem to take care of that well enough). The job requirement is far less glamorous and time-consuming, requires different skills, and if executed properly, will justify its own reward.

- *Voice to minority shareholders*: A discourse approach requires that the formal rights of minority shareholders are recognised substantively. There is an *equal* right to participate in the discussion about the firm, implicit to their *equitable* right to vote their number of shares. It is hard to believe that in a networked era, minority shareholders can still be barred from substantive participation through cumbersome paper-driven and legalistic proxy processes. Related to the assertion of this right to substantively participate is the right to nominate alternate directors.
- *Managing beyond a singular bottom-line*: It is incumbent upon the board to develop channels where a plurality of investor sentiments is voiced. Triple-bottom-line reporting is a start, not an end-goal. Social and environmental goals are laudable, but having them defined by the firm and in broad general terms may exclude intermediate strategic initiatives that could deliver value for specific firms. The work done by Hsieh (2005) in developing so-called "clumps of values" may be useful in identifying more specific initiatives that could serve firms well. Unlike the advocacy by some in the SRI and CSR movements, it is contended that a generic and mandatory system of reporting may have an undesirable effect. Rather, each firm should determine the appetite for its own plural concepts of value within the context of its specific market space.
- *Voice to stakeholders*: Shareholders have thus far held out rather successfully against normative claims for voice by non-owning stakeholders. I have argued that the capacity for uncertainty creation and mitigation adds more to the firm's fortunes than the passive and non-committed investment of mobile shareholders. The uncertainty metric offers an exciting alternative to ownership for determining the value of inviting specific stakeholders to the discourse about the firm. It also suggests that there are strict boundaries to stakeholder participation, which are harder to define or justify under a generic stakeholder model. In this sense, the need to prove a valuable relationship with uncertainty serves as entrance ticket to the discourse, and may render a

more discriminating stakeholder legitimisation than what a generic theory proposes. The important contribution of investors in providing financial resources to the firm is not underestimated. The effect of their contribution on the firm's ability to navigate uncertainty in the future guarantees shareholders a place at a table, even if uncertainty had to compete with ownership as engagement measure.

- *Rethinking the role of institutional investors:* Institutional investors offered an important bulwark to the earlier excesses of management, and are held in high regard in the governance reform movement. However, one should not lose sight that they are themselves corporations or quasi-corporations, and that their mandate fits solidly within the *investment-system* view of the firm, perhaps allowing for limited side-constraints, such as the CalPERS interest in its members' employment status. Fund managers sit as far down the nexus-of-contracts from individual members and their plural interests as may the CEO of the firm where the fund has invested. Despite having played a pivotal role in turning the direction of governance reform, we do need to ask whether institutional investors have not usurped the discourse around the firm for their own narrow purposes, and at the expense of minority shareholders and other stakeholders.
- *Managerial greed:* Finally, we need to consider how a new cultural conception might be able to address pressing concerns symptomatic of our current system, most visibly the problem with managerial greed and excess. A model built on selective stakeholder participation, using uncertainty as the major legitimisation criterion, places a heterogeneous set of competing interest-bearers into continuous discourse and re-evaluation. The inherent tension amongst these parties and the need to develop mutually advantageous relationships of trust significantly reduce the moral hazard that self-dealing executives have been able to exploit in the past. This tension also warrants a level of vigilance that has all but disappeared with the contaminated incentives for directors under the current governance regime.

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