CHAPTER 13

Corporate Governance and Ethics

LEARNING OBJECTIVES

Studying this chapter should provide you with the knowledge to:

1. Discuss the purposes of a corporation, including the shareholder primacy model and the stakeholder model.
2. Explain the role of the board of directors in governing the corporation and their duties to shareholders and other stakeholders.
3. Identify major ethical challenges managers face at each stage of the value chain.

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Governance Failures at Wells Fargo

In 1852, Henry Wells and William Fargo sat together in New York City and formed a joint stock company to provide banking and delivery services to a rapidly growing territory as far away from New York as possible: California. The new bank gained a reputation for dependability and trust in transporting shipments of gold and other financial projects over its stagecoach network. While technology has grown from coaches to split-second electronic exchanges, the stagecoach continued to represent the company's pioneering spirit, commitment to customer service, and, above all, reliability and trust.

Jim Collins and Jerry Porras wrote about Wells Fargo as a built-to-last company because of the bank's strategic discipline and commitment to its mission and vision over a number of decades and business cycles. The company's mission statement was a 37-page vision and values book that touted the company's commitment to customers, ethics, and trust.[1] During the financial crisis of 2007-09, Wells Fargo survived the meltdown that killed or crippled some of its strongest competitors. By the end of 2015, Wells Fargo was the most-trusted bank in the world,[2] and the bank's reputation for strategic discipline led pundits to list Wells Fargo as a bank that would stand the test of time.[3]

Within a year, however, many of those same pundits wondered whether the bank would survive a fall from grace. On September 8, 2016, three government agencies announced that Wells Fargo had been fined $185 million for opening more than 2 million accounts for its retail customers without their knowledge.[4] It seemed that a 37-page mission and vision statement, one that mentioned "trust" 24 times, was only so very many words on paper, but did not guide the bank's actions. Wells Fargo announced that it had terminated 5,300 employees for opening unauthorized accounts and apologized to its customers, saying "We regret and take responsibility for any instances where customers may have received a product that they did not request."[5]

Over the next few weeks, the driver of the renegade behavior became clear; it was not a group of rogue employees seeking to enrich themselves. The cause lay in a 2011 corporate incentive program that set aggressive quotas for new account openings, and backed them up with a carrot (bonuses) and stick (demotion or termination) incentive program.[6] Tellers and other employees would create new accounts for an existing customer—sometimes

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forging that customer's signature to open the account, and move a small amount of money from an existing account into the new one in order to get credit for a new account. The Los Angeles Times described one tactic:

> *Employees opened duplicate accounts, sometimes without customers' knowledge. . . . Workers also used a bank database to identify customers who had been pre-approved for credit cards — then ordered the plastic without asking them, [Erik] Estrada, [former Wells Fargo Personal Banker] said. "They'd just tell the customers: 'You're getting a credit card.'"*[7]

The focus soon turned from the incentive program to members of the executive team and the board of directors, with congressional investigators, federal regulators, and state attorneys general all wanting to know where the program originated, how the executive team could allow such an unethical and illegal practice to continue, and who had enriched themselves at customers' expense. Attention turned to Carrie Tolstedt, head of Wells' community banking division that housed the retail operations. Shortly before the scandal broke, Tolstedt, in her mid-50s, announced her retirement from the bank at the end of 2016. On September 27, the Board announced that Tolstedt had left the company and would forgo about $19 million in incentive compensation. The board also announced that CEO John Strumpf would also forfeit his $41 million bonus for the year. Strumpf found himself testifying before the Senate banking committee in late September. Sen. Elizabeth Warren, D-Massachusetts, called for Strumpf to resign and face criminal charges: "You should resign," she said. "You should give back the money that you gained while this scam was going on, and you should be criminally investigated." Sen. Jon Tester, D-Montana, noted that the scandal had worked a miracle in the partisan Senate; outrage about Wells' actions had created a united front among senators.[8] The board announced the immediate departure of Strumpf on October 12; longtime executive Tim Sloan would become CEO. He said his first priority would be to "restore trust in Wells Fargo."[9]

The fallout from the scandal continued into the fall of 2016. New account openings for November 2016 were off 40% from the number a year earlier, as customers fled a bank they couldn't seem to trust.[10] The bank faced numerous lawsuits from employees and customers affected by the fraudulent accounts scandal, and federal and state regulators all announced continuing investigations, and potential criminal charges against the bank. The oddest thing about the scandal and incentive program? Other than costing the bank its good reputation, the structure of the quota and incentive system resulted in millions of accounts that contributed nothing to the bottom line.

Wells Fargo's ethical lapse highlights the issues, challenges, and problems of corporate governance and the importance of ethical behavior by those who sit at the top of a company, specifically, its executive team and board of directors. You may be thinking, "Just what is governance? I thought that we *elected* governors but corporations *hired* managers?" In this chapter, we'll use a metaphor that should help you visualize the importance of good corporate governance. The metaphor comes from the history of the word *govern.* The English word *govern* traces its root back to in the ancient Latin word *gubernare*, which meant to steer or pilot a ship.

This metaphor paints an accurate picture of governance; it's about steering the corporation. The notion of steering raises three simple questions about governance that all corporations must answer: Where will we steer the corporation? Who will act as the pilot? How will we steer, or what principles will guide the journey? This chapter is organized around these three key questions.

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The Purposes of the Corporation

corporate governance The processes and structures that provide the ultimate decision-making authority for the firm.

corporation A legal structure for organizing where the organization is a distinct and separate entity from its owners, also known as shareholders.

individual proprietorship A legal structure for organizing where the same person owns and runs the business.

partnerships A legal structure for organizing where the owners of a business share ownership. The partnership is not separate from its owners.

If we ask where we want to steer anything, be it a boat, a car, or a business, we are also asking where we want to end up, or what the goal is that we are trying to achieve. In terms of **corporate governance**, this question is often worded in one of two ways: What is the purpose of the corporation? Or, who is the corporation run for? A **corporation** is a legal structure for organizing a business that is considered a distinct and separate entity from its owners, also known as shareholders. For the last 80 years, those questions have had at least 2 answers. The corporation should either be run for the shareholders or be run for the stakeholders. To understand the implications of these answers, it is important to understand a little about the history and evolution of the corporation in the United States.

For the first 100 years of our nation's history, corporations were very rare. Most economic activity was carried out by **individual proprietorships**, where the same person owned and ran the business. Many small businesses today still operate as proprietorships. Some businesses operated as **partnerships**, a business owned by two or more partners. Today, law firms, accounting firms, medical practices, and other professional service firms typically organize as partnerships. Corporations that issued stock, or shares of ownership, to investors were rare. If

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you wanted to form a corporation, you had to go to the state legislature to obtain permission to begin and to sell stock. That right came in a document known as a *charter*. That charter authorized you to form a corporation for a very limited purpose, such as building a canal, a railroad, or a turnpike. There was no debate about the purpose of the corporation because its purpose was clearly outlined in its charter.[11]

As the twentieth century dawned, states relaxed their hold on the corporate form because people realized the limited liability and dispersed ownership that came through incorporation allowed these entities to industrialize and grow the larger economy. Eventually corporations could be formed for whatever purposes the owners wanted to pursue. One way these general-purpose corporations grew was to offer investors a share of ownership in the company, or stock. Those investors contributed their money but relied on managers to run the corporation. During the nineteenth century, the owner and operator of the businesses were most often the same person, while in the twentieth century, as large organizations emerged, ownership became increasingly separated from management control of the corporation's resources.[12]

In the 1930s, two famous law professors, Adolf Berle and Merrick Dodd, held a very public argument about the purposes of the corporation. Professor Berle believed that the corporation should be run primarily for the benefit of the shareholders while Professor Dodd wrote that the corporation should be run for the benefit of the entire community.[13] We know Berle's position today as the **shareholder primacy model**, and Dodd's as the **stakeholder model**.

shareholder primacy model The belief that a corporation should be run, primarily or exclusively, for the benefit of its shareholders.

stakeholder model The belief that a corporation should be run for the benefit of its entire stakeholder set, with no group enjoying primacy in decision making.

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The Shareholder Primacy Model

In earlier chapters of this book, we've explained how a business can be thought of as a bundle of resources and capabilities, physical assets such as buildings or equipment and skills, knowledge, and processes. Just as the business itself represents a bundle of these resources, the corporation, the legal entity that is the business, can be thought of as a bundle, or a **nexus of contracts** between participating parties.[14] Suppliers contract with the firm to provide needed inputs, employees contract to provide labor, and even distributors and many customers purchase goods from the corporation through a sales contract. Governments contract with the corporation through a business license and tax authorities. Lenders and bondholders have explicit contracts that outline specific payment schedules and terms.

nexus of contracts A model of the corporation suggesting that the firm is the sum total of its contracts with different stakeholders.

Advocates of the shareholder primacy model believe that shareholders have a special type of contract with the corporation. Unlike other stakeholders, investors exchange money with the corporation without a clearly specified payment in return. Shareholders put their money "at risk" without a guaranteed return, but in exchange, they receive two **property rights** from the corporation. First, shareholders have claim to the residual earnings of the corporation, or the profits after all other stakeholders have been paid. Second, shareholders buy the right to monitor the management team to make sure that the team works in their best interests.[15] The first right specifies their reward for investing their money, and the second right protects them from being taken advantage of by the management team by providing them with oversight rights.

property rights The rights of owners to: (1) claim the residual earnings of the corporation, or the profits after all other stakeholders have been paid, and/or (2) monitor the management team to make sure that the team works in their best interests.

Proponents of the shareholder primacy model usually cite 3 reasons for their support. First, the shareholders are the legal owners of the corporation's assets.[16] The executive team is hired by the board of directors, the shareholders' oversight group, and should be legally and morally obligated to work for the owners of the corporation. Second, proponents of the shareholder model claim that financial capital is the most important input into making a business successful. Without funds it's hard to hire employees, buy inventory or other needed inputs, and produce products for customers to buy. Finally, advocates of the shareholder model point to other societies and business arrangements in which business firms try to maximize the welfare of some other stakeholder group—such as employees or the local community. They observe that corporations run for these other stakeholder groups don't really maximize welfare for those groups and often cause real damage to economies, communities, and the natural environment.[17]

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