CORPORATE SCANDALS AND ANCIENT ETHICAL WISDOM

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The corporate scandals that have rocked the American business sector over the last two years have left an indelible impact on various levels. First they left the managerial class severely bruised with accusations of self-dealing. Second, they destroyed small and large fortunes for many shareholders. Third, they provided the impetus for new regulation, the most significant example being the Sarbanes-Oxley Act of 2002. Most important of all, however, has been the damage done on people's trust for the dual pillars of modern capitalism, the corporate enterprise and market system as mechanisms for the efficient allocation of capital and the preservation and growth of society's investable wealth.

Under ideal conditions, corporate capitalism is about firms financed by a multitude of shareholders and managed by professional managers. The diffused ownership is an efficient method for risk sharing while the professional specialization of managers guarantees efficient day-to-day management. The implicit contract in this setting is that the managers act as agents of the shareholders-principals, meaning that managers have a fiduciary responsibility to manage the firm according to the interest of the shareholders. This interest has been understood to be the maximization of the shareholders' wealth invested in the firm and reflected in the market value of the shares. This is where the market enters the picture. Values for the firm's securities, shares, as well as bonds, are set in the capital markets. Consequently, we have the emergence of a pair of two-way relationships: the managers vis-a-vis the shareholders; and the firm vis-a-vis the financial markets. To work well, these relationships require the respect of certain rules by each party.

Diffused ownership and managerial control of the firm's assets can produce an unstable relationship between managers and shareholders, fraught with conflicts of interest. Managers, if only compensated with fixed salaries, have less incentive to exert their best effort to maximize value. Shareholders, who rely on dividends and capital gains for compensation, can put pressure on managers by either selling their shares or accepting the tender offers of corporate raiders. In the 1980's the wave of hostile takeovers, fueled by the drive of shareholders for maximum value, was resented and questioned, especially by managers who felt threatened by the demand to produce financial market value. Writing in a *The Wall Street Journal* (Oct. 16, 1986), John Smale, then chairman and CEO of Procter & Gamble Co., accused the market of being dominated by "temporary owners" looking for the fast buck. The academic management guru, Peter Drucker, echoed this sentiment, also in *The Wall Street Journal* (Sept. 30, 1986), by stating that corporate capitalism had devolved to "speculator's capitalism." The usual allegation in the 1980's was that the interests of the corporation had been subordinated to the interests of the owners. Thus, corporate capitalism had turned into "shareholders' capitalism." Its critics alleged that shareholders capitalism drove managers to short-termism at the expense of the corporation's long-term growth and health. Moreover, serving shareholders' interests, the story

continued, was done at the expense of other corporate stakeholders, like employees (displaced by mergers and downsizings), suppliers, customers, and local communities. Although unchecked and myopic pursuit of shareholders' interest for short-run gain can be ruinous for the corporation and detrimental to economic growth, a closer look reveals that the shareholders' revolt of the 1980's was justified and more beneficial than disastrous. First, shareholders were reacting to the managerial behavior of 1960's and 1970's. In those years, managers had attempted to build sprawling corporate empires through mergers with little regard for return on investment, and, hence, value. Second, there was no serious evidence produced that firms really neglected the legitimate interests of stakeholders, other than shareholders, or the market failed to see beyond the short-term horizon.

Ironically, however, the drive for value elevated the importance of managers as producers of value. This led to giving managers generous compensation packages that included firm stock and stock options. An article in the *BusinessWeek* (May 6, 2002) reported that, by the late 1990's, CEOs of U.S. corporations earned compensation that averaged 411 times the average compensation of factory workers. The same year, an article in *The Financial Times* (November 20, 2002) reported that top executives had amassed \$3.3 bn. from companies they led into bankruptcy. Therefore, the need to make managers behave as shareholders and thus put priority on value maximization, had created incentives that could lead to perverse behavior. Managers not only had an interest in seeing their stocks and stock options rise in value, they also had control of their firm whose prospects were responsible for that value. Unscrupulous managers could conceivably manipulate accounting rules, transactions and information disclosure with the goal to effect a temporary market impression that the firm was doing better than anticipated. As soon as the stock price would rise, these managers could cash in their stocks and stock options and thus reap tremendous profits before the market became cognizant of the true condition of the firm. The problem was compounded by the fact that many unethical managers found willing accomplishes among the ranks of financial analysts and investment bankers whose duty was to reveal the true information to their clients. In the 1990's, therefore, it was the short-term interests of the managerial class that could jeopardize the integrity of the system. This time, the failure of corporate capitalism had to do with the quality, or rather lack of, of the information the market needed to appraise the value of firms. This represented, therefore, a breakdown in the relationship between the corporation (in the hands of managers) and the free market. The shareholders' capitalism of the 1980's had morphed into the managerial capitalism of the 1990's.

In both instances, the rallying cry against the perceived or real excesses was that the responsible parties, be it shareholders or managers, were motivated by uncontrolled greed. Some critics went even further by equating value maximization with greed and thus raising questions about the moral base of value maximization as a corporate goal. The losses suffered by millions of individual shareholders, pension funds and employees of corporations, like Enron, Worldcom, Adelphia and Tyco, put pressure on the Congress and the White House to take immediate and dramatic action. The result was the quick writing and easy passage of the Sarbanes-Oxley act. The purpose of the act is to oversee the application of accounting practices and standards in the auditing of firms; to remove conflicts of interest in accounting firms with consulting business; to make executives personally responsible for the accuracy of the financial statements of their firms; and to enhance the criminal penalties for persons responsible for corporate fraud. In addition, the two largest U.S. stocks markets, the New York Stock Exchange and the Nasdaq Stock Market, are in the process of adopting stricter requirements regarding corporate governance rules. Similarly, the Securities and Exchange Commission is looking for additional

regulation and accountability of executives and corporations. To correct the abuses perpetrated on investors by analysts and investment banks, the New York State Attorney General, Elliot Spitzer, moved successfully to impose a collective settlement of $1.4 bn. so that investment banks would clean up their act and provide some restitution to victimized investors. Finally, in the biggest punishment of all, investors have pulled huge amounts of cash out of the stock market because of distrust of corporations.

Despite, these punishing consequences, many commentators are doubtful about their efficacy and wonder whether we need to re-examine fundamental premises of the ethics and goals that permeate the organization of the modern corporation and the working of the financial markets. It is at the juncture of such developments that we need to go back to the roots of ethical philosophy and raise the question "What can ancient Greek ethical philosophy and attitudes can teach us about today's corporate lapses? What can we learn from the ancient classical wisdom?"

The need to serve the common good: From the polis to the market. Loyalty to the polis (city-state) was the central principle of the social and political conscience of ancient Greeks. In his funeral oration, Pericles spoke of the good things that the polis bestowed on its citizens and how both the citizens and the polis must look after each other's interests. Socrates, advised that the fatherland (patris) was to be esteemed as holier and more honorable even than one's parents. He refused the pleading of his students to flee before his execution because this would represent betrayal of the laws of his polis. So the Greeks treated their polis as the ultimate social and political good. Given the importance Western liberal societies ascribe to the market system, the Greeks would have advised us to think of it as an ethical good. Although neither the city-state nor the market is the ultimate moral good, ideally, each has the ethical aim to enable people to realize their highest good. This would dictate that we safeguard the market's integrity, meaning that we do not deliberately distort the information people need to have to make fair judgements about the values of the goods they trade, whether these are securities, used cars, or anything else. When people do not trust information given to them, they treat all goods as potential "lemons" and withdraw from the market. This is what economists call "the adverse selection" or "the winner's curse" problem. You select, on false information, what turns out to be an inferior good based on the true information you learn later. Interestingly, Socrates spoke of that peril in one of the dialogues when he admonished: "Hippocrates, you can not carry learning away in a jar. Once you have paid for it, you must accept it directly in your soul, and having learned it you must live with the harm or benefit inside you." The corporate scandals of recent years demonstrate a clear lack of a market ethos by those that ought to have the greatest allegiance to the market, that is, top corporate executives. Instead we have seen the display of personal and quick gratification at the expense of a higher good that is essential of the type of society we espouse. These failures also show that Adam Smith's prescription that individual action based on self interest maintains competition and engenders economic prosperity is not entirely workable when taken to the extreme of ethical egotism, that is, when maximizing personal utility becomes the guide for one's actions. Individuals as economic agents interact within a social mechanism - the market - whose well-being is also of paramount importance. An ethos of individual utility that supplants the ethos for the common good, i.e., the market, is not a viable prescription for economic behavior. It is interesting to note that at about the same time the ancient Greeks were developing their ideas about the polis, Confucius in the Far East was developing his philosophy of social harmony and consensus, that is known as *Wa*.

The need for moderation: From value maximization to greed. What is the ethical base of economic value maximization? Is it synonymous to greed? It is plausible to argue that value which is not associated with efficiency in the utilization of economic resources lacks ethical justification. Society depends on the use of scarce resources (capital) to satisfy its various needs. The market functions well when it channels capital to the enterprises that can use it best to produce maximum output and thus satisfy the greatest amount of needs. When this happens, such enterprises deserve to be rewarded with maximum value. This value is none other than what investors are willing to pay to buy and hold the firm's capital stock. But this flow of events requires that investors have fair and full information so they can judge how well firms utilize the capital entrusted with them. When managers or other intermediaries distort this information, the market can possibly divert capital to firms that destroy it through wasteful or unwise actions (e.g., Enron). Then society's capacity to satisfy its needs is diminished. This thought process shows that value maximization is not an option but rather a moral imperative for those who run enterprises, whether of the private or public sector. Value maximization, although not synonymous with greed, it depends on it. It is greed that capitalism uses as an incentive to derive maximum effort from the individual. Greed as an incentive to produce value based on economic efficiency works well for the individual and the society. Uncontrolled greed, on the other hand, can sacrifice both, economic efficiency and value. This happens, for example, when company managers and/or owners try to distort information so they can trade their stock holdings with and reap profits from unsuspected investors. Balance and moderation was the hallmark of ancient Greek wisdom. The words had come from the oracle of Delphi: "everything in moderation." Aristotle advocated that lack of balance can turn anything from good to bad. Greed in its unethical form is the pursuit of value without serving economic efficiency. Since greed is the byproduct of a person's desire to satisfy an ever expanding amount of needs, a society's intensity for value maximization can be said it is directly related to the quantity of needs a society generates. Therefore, an ethical critique of any excessive preoccupation with value maximization should rather be directed to the failure of societies to check the growth of their needs. The following is an exchange between Socrates and Kalikles in Plato's dialogue *Gorgias*.

> *Kalikles:* The best life is enjoyed by the man who lets his desires and passions grow as ravening and insatiable as they can, and takes care that he has always present the means of gratifying them.
>
> *Socrates:* Compare the soul of such a person to a sieve, because this kind of soul cannot hold anything and thus can never be full with a finite amount of things."

About nine centuries later, the student of classical philosophy, St. Augustine, said the same this way:

> "Rich is not one with great wealth but one with few needs; and poor is not one with little wealth but one with many needs."

Although we can not cease to pursue economic efficiency, and thus value, we can learn to be moderate in how we grow our needs, especially those that seem to place a great burden on the environment and our competition with others for the scarce resources of our world.

The need for ethical education: From preparing for good lives to preparing for careers. More than ten years ago, the accrediting agency for business schools, AASCB, mandated that the curriculum should include instruction on business ethics. Despite the good intentions of this

requirement, modern education is more geared to giving students the skills and knowledge for successful professional careers than the training to understand the ethical aspects of their professional as well as every-day lives. The French philosopher Pierre Hadot writes "[T]he goal of education is no longer, as it was in antiquity, to train people for careers as human beings, but to train them for careers as clerks or professionals, that is to say, as specialists, theoreticians, and retainers of specific items of more or less esoteric knowledge." (*What Is Ancient Philosophy*). The emphasis of ancient Greek education on ethics is exemplified in what Alexander the Great have said of his education: "My father gave me life, but my teacher (Aristotle) gave me the good life." And by "good life" he did not mean "dolce vita."

The need for knowledge: From ignorance to virtue. Mainstream ancient Greek ethical teaching was hostile to ethical relativism as practiced by the Sophists. To Protagoras's "man is the measure of everything," Plato's Socratic voice retorted with "virtue is knowledge." Through teaching and training, people could understand to distinguish good from evil and pursue the former. Or could they? Plato recognized the difficulty of ethical teaching when he cautioned that a person should not approach professors of virtue - arete - unless one already knows whether what they offer will help or harm the soul. If one needs to know about arete, however, one must know very little of it. How is then one able to recognize it in what is taught? And if one can pick the right teacher of ethics (arete) then one needs no such teacher! This is a humbling note and reminder to our modern efforts to teach ethics to students.

Because ancient Greeks were great thinkers of the human condition it did not imply their contemporaries lived by the philosophers' instructions. The "guards" Plato had placed at the top of his *Republic* were not necessarily above self-interest. When the Delian Fund, established under the aegis of Athens with contributions of the members of the Athenian Commonwealth, came to be a very sizable amount of money, Pericles did not hesitate to transfer it to Athens and use it to build the Parthenon. The expropriation of the wealth of the allies (i.e., the shareholders) by the Athenian republic (i.e., the manager) was an egregious case of the moral hazard problem that still afflicts organizations. (Plato would have plausibly quipped that Pericles had paid the wrong teacher to learn (the wrong) ethics.) However, the lesson is that for every disinterested and selfless individual (like Socrates) there is more than one self-dealing person. At the end of every lofty and inspiring school of social ethics, there lurks the reality of human fallibility. That's where law that proscribes behavior, harmful to the common good, and punishment that maintains accountability become the last line of defense of pragmatic societies.

In the end, Aristotle would have admonished us to heed the ethical teachings of his times but would have also instructed us to take the "law and order" measures that compel the citizenry to steer away from actions that harm the common good.