Corrupt Groups in Contemporary Corporations: Outside Boards and Inside Traders

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We are awakening from a nightmare of hero-worship. The Corporate CEOs that recently we venerated, studied, and lavishly compensated, have lost their luster. Partly, of course, this has to do with the scandals that have been unearthed at Enron, Adelphia, WorldCom and so forth. In the harsh light of these failures, our heroes look disturbingly fallible. Even those who have not been accused of fraud are now looking greedy and selfish. But more important in explaining this dramatic turn-around in hero worship, I think, is the fact that our economic bubble has burst; the larger-than-life figures we celebrated for their success in delivering ever-higher stock values have turned into scapegoats for our depressed portfolios and straightened circumstances.

The dramatic change has all the earmarks of a projective process, but that is just the beginning of knowing something useful. What I would like to do in this paper is focus in on how and why this happened and the effects that this nightmare has had on our corporations. There tend to be two schools of thought on the subject of corporate corruption: those who see "bad apples" and those look for "rotten roots" (Micklethwait & Wooldridge, 2003) Typically, following conventional wisdom, the press go after the "bad apples," the individuals who are singled out for celebrity and blame. Thus we have Ken Lay, Bernie Ebbers, Denis Kozlowski, and so forth, our current collection of culprits. The "rotten roots" school, often favored by legislators, looks at the structural issues that can lead to legal and regulatory solutions. Thus we have Sarbanes-Oxley. Here, however, we have another approach available to us that recognizes the power of the unconscious and the capacity of groups and systems to distort reality. There are bad apples and rotten roots, just as there are individuals to be prosecuted and laws to be changed, but there is also anxiety associated with work, social defenses, and fantasies collectively designed to screen our awareness of difficult realities. Here we are led by our desire to understand and our capacity to recognize that, as Sullivan put it: "We are all much more human than otherwise." And, being human, we can come to grips with the recognition that we have all done this together.

But first, let me provide the context for these developments. How did CEOs become so celebrated and powerful, and why?

To begin with, many of our large corporations today have become more influential and powerful than government itself. It is not just that their assets and revenues rival those of many western democracies, but that they have the ideological edge in debates about public policy. It was the unrivaled economic power of our corporations that outperformed the Soviet empire, forcing it into a disastrous arms race that ultimately led to bankrupcy. But even on our side of the wall, governments increasingly resorted to privatizations in recognition that state run enterprises tended to be inefficient, bureaucratic, and unadaptive. There are more and more calls for deregulation and smaller government, in order to unleash the economic power of corporate competition.

In an era of globalization, moreover, governments are less able to assert control over corporations, given the capacity of multinationals to move their resources across national boundaries. Within those boundaries, moreover, corporations dominate electoral and legislative processes through their financial contributions to political campaigns and lobbying power. Often through ingenuous means that circumvent government attempts at regulation, corporate donations fuel the ever more expensive marketing campaigns that now substitute for public discussion and debate. At the same time, corporations hire former senators and representatives, cabinet secretaries, legislative assistants, and so forth in order to influence and shape the legislative process.

But while corporations are growing in power, their purpose narrows. The very power of the market that gives them their extraordinary influence constrains their ability to act. The forces of "investor capitalism" require them to maximize the value of their shares. The massive influence they wield must be used in the service of an ever spiraling competitive drive to trim waste, sell off unprofitable assets, find new markets, down size or "right-size," in order to make sure that their quarterly balance sheets reflect ever-increasing profitability. The development of "investor capitalism" in the last several decades means that companies have, in effect, become hostages to their stock prices.

Originally, of course, stock markets existed primarily to raise capital. Investors risked their money on the hope – by no means the guarantee – of making profits as that capital led to greater returns. A 1948 poll found that 90 percent of Americans were opposed to buying stocks as an investment, either because they were unfamiliar with them or thought them "not safe," a "gamble" (Berenson, 2003, p. 34). Today, we are all invested. Most restrictions on investments have been eliminated. As a result we have all become dependent upon increasing stock values, through pension plans, individual retirement accounts, savings, endowments, insurance, reserves, and other investments. The public

expects increasing value on its investments. It no longer takes risk for granted.

These dual forces operating on our corporations -- their increasing social and political power, on the one hand, and their increasing focus on shareholder value in response to public pressure, on the other – define what has come to be the task of the CEO. With increasing prestige and influence at the top of these enormously powerful enterprises, they are required to satisfy the narrow demands of investors for profitability. They are expected, in short, to provide economic security for the investor public. They are the leaders of what has sometimes been called "populist capitalism," and the rewards of success have become immense.

There is clearly a profound irrational dimension to this scenario. Capitalism, based on competition and risk, has now been pressed into the service of providing for our social security. All the deprivations and risks of our social existence, we had come to believe, could be dealt with so long as pension plans, savings accounts and other forms of investments continued to rise. Governments depended on this continuing success, as well, as rising profits meant increased tax revenue to pay for social services. To be sure, the gap between the rich and the poor continued to grow, but as the poor had little economic or political clout or could be distracted by sophisticated election campaigns, that scarcely mattered.

The market has triumphed, and the CEOs became the unquestioned leaders of this new order. Those who rose to the occasion were often exceptional men, to be sure. Motivated by narcissistic desire to play a visible and high-stakes role in society (Maccoby, 2000), they also stood to amass extraordinary fortunes. But they were, after all, only men. Given credit for achievements they had little responsibility for accomplishing in past roles, acclaimed for the promise of future turn-arounds, they became the objects of a cult. In effect, in the service of this demand for charismatic brilliance, we created a new aristocracy, rivaling the robber barons of the nineteenth century, but the power of their role derived from the fact that they enacted a kind of social defense on our behalf. Their job was not only to deliver increasing shareholder value but also to sustain our belief that this was possible in the "New Economy" and the "New World Order." They embodied a fantasy of omnipotent control over the risks and contradictions of the market.

In his study of CEO succession, Rakesh Kurana (2002) noted how resistant boards of directors were to the research that challenged this omnipotent belief: "It is difficult to convey to the reader how deeply rooted this belief in the dependent relationship between CEO quality and firm performance is among members of corporate boards, who hold it

with virtually religious conviction. To openly question it is taboo" (p. 110). Boards may have a particular need to sustain this fantasy, as their judgment and responsibility is at stake in selecting the CEO, but to a lesser degree we all shared in it.

One way for this new breed of CEO to manage the expectation of providing increasing values for shareholders was to make the corporation itself the new locus of insecurity, ratcheting up the internal pressure and the anxiety to perform. Empowered with their new mission, CEOs turned against the security that the corporation itself had traditional provided to its employees. Loyalty to employees was discarded, productivity continually scrutinized, even whole units or sectors discarded for strategic reasons, regardless of productivity; in the new corporation, no one felt secure. Lower-level employees worked longer hours, and overall compensation declined to the point that most families now require both parents to work in order to make ends meet (Hertz, 2001). Top executives gained stock options and other perks.

Another strategy to increase profitability was to minimize the expenses of social responsibility. While managerial capitalism increasingly had been expected to balance the competing pressures of profits on the one hand and worker safety, community and environmental responsibility, on the other, the new CEOs pared these efforts and their costs. Many enlightened capitalists in the past created worker communities or, like Henry Ford, raised wages so that employees could afford to buy consumer products. But now, as a result of the intensified pressure of profitability and the relentless scrutiny of financial analysts, corporations became increasingly unable to bear the additional costs of decent medical benefits, arts subsidies, support for community projects, etc. Pressured to meet quarterly projections, they were even constrained from thinking long-term.

For CEOs to take up this new task they had to mobilize power in the corporation in unprecedented ways. Perhaps more accurately, for this new delegation of economic and psychological responsibility to occur, the corporation had to reconfigure itself. I want to focus here on two key changes that have had profound implications -- and consequences. These changes will help us to understand the scandals that have shaken us and exposed the basis of the social fantasy we have been living. On the one hand, the CEOs had to be given unprecedented new power by their boards of directors, undermining the ability of those boards to provide oversight to management. On the other, the CEOs had to mobilize new cadres to carry out their mission, often in the face of immense resistance within the organization itself. These new lieutenants had to demonstrate loyalty to the CEO, not the company, as well as

exceptional drive and capacity for innovation in order to meet the new goals of profitability. They took the risk and, inevitably, they often skirted the law. These are the men and women who engaged in the creative bookkeeping and other daring innovations in order to carry out the mission of the CEO.

Let's start with boards. Historically the role of corporate Boards has been to oversee management and to represent the interests of shareholders. But boards withdrew from that historic focus and ceded control to CEOs as the CEO's job became increasingly to focus on shareholder value. In the process, boards increasingly aligned their interests with the CEO. Sharing ever-increasing bonuses of stock options, they eroded their capacity for oversight.

Most board members today think their main responsibility is to select their company's CEO (Khurana, 2002). The qualification for the CEO's job is their "charismatic" ability to restructure and revitalize the corporation in order to maximize profit; but, paradoxically, the means the boards employ to select a new CEO often undermine their ability to succeed. Increasingly, they look outside their own organizations at corporate leaders they have little first-hand knowledge of. Moreover, they are often deferential and reliant on search firms to mediate the selection process; hard questions are avoided. From the outset of the selection process, they create for themselves a diminished responsibility.

Moreover, new CEO's typically now demand the role of Board Chairman as a condition of accepting the job. As a result, currently the CEO is also the Chairman of the Board in 80% of Fortune 500 corporations. The rational for this is that it is easier for the CEO/Chair to manage the complex resources of his organization if he can count on the support of the board, if he is not also distracted by having to manage a potentially adversarial role with a group of watchdogs. In addition, the CEO often changes the composition and the size of the Board when he is hired, and nominates new members. The new CEO, of course, wants to protect himself from the risks of a critical Board. But in the process of solidifying his control, he further undermines the capacity of the Board to function independently.

Nor is it unusual for board members to have consulting contracts with the companies on whose boards they sit, or for the companies where they work to have significant business relationships with the companies they oversee. Their independence as a result is compromised. Board members, in addition, are often drawn from similar backgrounds and maintain outside relationships with each other through other corporate boards as well as country clubs, charities, and national associations; as

Useem (1984) pointed out, board members collectively form a kind of national community, with strong common interests and identities.

In such environments, "groupthink" flourishes (Janis, 1986). Board members have a chairman, often also CEO, they have selected and want to support; they receive limited information. Usually small in size, operating in secrecy, they are prone to the unconscious motives of maintaining cohesiveness and preserving their established business identities and their self-esteem. As a result, they will often collude in ignoring disturbing information, in accepting excuses, stifling criticism. Or – sometimes worse -- they will overreact to crises and search for outside saviors when it becomes obvious that the CEO is not performing to expectation. "Groupthink," otherwise known as "basic assumption" behavior (Bion, 1959), if it does not protect and preserve internal cohesiveness and comfort, leads to panic and desperate, irrational behavior. Dependency gives way to fight and flight.

Today the idea of the CEO as corporate savior is waning. Boards too are receiving more critical attention. Recent corporate scandals inevitably raise questions about role of the Audit Committees or Compensation Committees of the various boards where irregularities and excesses occurred. Boards can – and do – claim ignorance. They can easily be misled. But while this fact may well immunize them from prosecution, less so now with Sarbanes-Oxley, it is hardly sufficient to make them responsible. What is required is a larger systemic perspective which raises the question about the purpose and function of boards and how they allow themselves to become ignorant or marginalized.

The second aspect of the larger system I want to turn to:
What I call "insider groups," the groups that function underneath top management. Focusing on the CEO "saviors" who garner the headlines, we tend to ignore the shifting groups of lieutenants that advise and support them, that feed them information and carry out their orders. We don't see them, that is, unless they are caught and prosecuted for conspiracy. Inside the organization, groups of traders, managers and accountants are pressured to come up with the figures that will prop up share prices. Acting on behalf of the CEO, though often without his direct knowledge, they act to reinforce the competitive position of the corporation in the marketplace of investors. They utilize "insider" information to gain extraordinary profits, negotiate "insider" agreements to restrain competition, or reconfigure balance sheets to produce profits.

If one reads about the long and arduous process of investigating such groups, one becomes aware of how widespread the problems are, how few get indicted, and how limited the punishments are. On the other

hand, "insider groups" are not necessarily engaged in illegal activities. Indeed, it is probably fair to say that at least as often as these internal pressures lead to corrupt practices they also produce exciting innovations, new methods and products of genuine value. The point is that such groups in their highly pressured commitment to the task of carrying out the CEO's agenda of increased profitability are continually pressured to test the boundary of legal or ethical practices.

Another way to put it is that, in the age of "investor capitalism," the insider groups of loyal lieutenants are driven by top management to produce results with less and less regard to how they do it. They become so caught up in a group process to achieve their goals, that legal and ethical considerations fade away. Barbara Toffler (2003) in her account of providing consultation in ethics to clients for Anderson noted: "I found myself giving pitches for stuff I didn't even believe in." (p. 57). Moreover, as these "insider groups" often have the assignment of bucking the corporate culture, acting against the entrenched hierarchies, they operate without the restraint that might be provided by others in the hierarchy who now come to be seen as old-fashioned and resistant to change.

Jack Welch, "The CEO of the Century," was well known for his strategy of tapping aggressive and bright young men, potential "winners," dazzling them with prospects on the inside tract, leaping them over older and more experienced executives, offering them bonuses, perks, and stock options, in order aggressively to raise the profitability of their sectors. Free of traditional loyalties, they were committed only to him and to his goal of profitability. Typically, the new insider, embraced his assignment with extraordinary drive and creativity. Constantly reminded that GE was a company that disclaimed loyalty, he had to justify his status and rewards repeatedly. It was a brilliant strategy.

But "winners" could turn into "dinks." Not only would they have failed to justify his support, to meet his goals, they could be turned into scapegoats for problems that developed along the way.
There were always "rogues" to blame. He himself was seldom tarnished. One former GE employee said: "there is so much pressure to make the numbers that a lot of people were tempted to do things. Either Jack really doesn't know or doesn't want to know…." Another said: "Nothing the company did would surprise me, and I mean nothing. (O'Boyle, 1998, pp. 238-9)

We need to keep the psychology of the insider individual in mind: Often motivated by an inner sense of not belonging, the insider is not only dazzled by the opportunities offered, but his temptation is doubly

reinforced by the desire to make it in a world that is not usually open to him.

But there is never <u>an</u> insider. To be effective, an insider has to have a group he is a part of. Each organization that participates in price fixing, for example, must have its own collection of insiders who are not only aware of the negotiations but also involved in setting or agreeing to their terms. Groups that engage in creative accounting procedures, as well, do not work in isolation or for their own ends.

At GE, during the same years of its phenomenal growth, there was a flood of scandals resulting from this pressure and from the collusive behavior of insider groups: Price fixing with de Beers, insider trading and illegal accounting practices at GE Capital, environmental damage along with attempts to deny responsibility and thwart restitution, contract fraud with the Department of Defense. At one point the DOD set up a special office to audit GE contracts, and over three years recovered $71 million from over a hundred irregularities. This is the less well-known side of GE's success story.

A more notorious example of this process is provided by Al Dunlop, the CEO of Scott Paper and then Sunbeam. Marx once remarked that history repeats itself, once as tragedy and then as farce. If Jack Welch is our tragic hero, "Chainsaw" Al Dunlop became his caricature, repeating the story with exaggerated and embarrassing results.

Dunlop imitated Welch's strategy, at first with great success: discarding marginal businesses, downsizing, closing factories, cutting costs, emphasizing more profitable product lines. As a result of such drastic measures at Scott, he developed a reputation for turning the business around and selling it at a substantial mark up: Kimberly-Clark bought Scott for $9.4 billion, a rise of 225 percent in shareholder value. But after Scott was taken over, the hidden costs of this spectacular "turn-around" eventually surfaced and tarnished his reputation: instead of a projected $100 million income in the forth quarter of 1995 from Scott's business, Kimberly-Clark lost $60 million (Byrne, 1999,p. 32) But the chief investors at Sunbeam, dazzled by his "success" at raising the share price at Scott, eager for similar "turn-around," hired him to repeat his performance.

At Sunbeam, he told his new recruits that "sixty-two of his executives and managers at Scott Paper became millionaires when they cashed in their stock options" (p. 42). He promised greater and faster rewards to his new "Dream Team." And they went aggressively to work. But when, after cutting costs drastically and boosting profits, he failed to find the

purchaser for the company he strategy depended upon, the price of his "success" eventually surfaced. Inventory stuffing, poor quality control, no factory repairs, outmoded products, etc. collapsed the company's value within two years.

Here I am in danger myself of appearing to scapegoating CEOs, joining the crowd turning against our former idols, now that the boom has ended, our stock market bubble has burst. "Chainsaw" Al's story is extreme, but what he did was possible because of the dynamics of investor capitalism and the CEO cult it gave rise to. He was able to execute a virtually complete divorce between real value and shareholder value, leading, of course, to the ultimate collapse of shareholder value. Most CEOs, wisely, did not take that route. Welch, for example, famously promoted "Six Sigma" as a means of promoted quality control, something Dunlop would no doubt have thought of as too expensive and long-term. I suspect Welch understood the long-range danger of his focus on profitability to shareholder value, and instituted "Six Sigma" as a draconian counter-measure. But, probably, he did not do it entirely alone, without advisors and lieutenants, though he alone got the credit. And I don't think he did it without paying a price.

The point is not to scapegoat CEO's, boards of directors, or, even, insider groups, but to de-mystify the disavowed and neglected forces that are increasingly corrupting our public life. From a systemic viewpoint, we are creating heroes and villains in these dramas, ignoring the mundane and pervasive importance of these issues to our daily life as citizens and investors.

Now disillusioned with our heroic CEO's, we blame them for their narcissism and greed. Those targets of self-deception are in our sights. But that could be an act of self-deception on our parts if we focus only on their flaws, their excessive ambition, their inflated, shallow characters. I would argue that we got – and we get - the CEO's we deserve; we didn't want to know that these goals of ever increasing stock values could not be met. We allowed ourselves to become blinded. Focused on our constantly increasing mutual funds, our investment portfolios, our pension plans, our endowments, we did not think of the cost. And the CEO's, the CFO's, the COO's etc were blinded to the risks they were running, setting up the management structures designed to squeeze their subordinates to perform, dismantling corporate loyalty, replacing it with the insider groups loyal only to them, designed to enhance their performance and the bottom line.

I don't mean at all to suggest that our current villains are not guilty or do not deserve punishment. But that doesn't take us very far.

Where the pressures and temptations remain the same, new candidates for fame and infamy will always appear.

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