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James A. Fanto

Brooklyn Law School, james.fanto@brooklaw.edu

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CORPORATE MISBEHAVIOR BY ELITE DECISION-MAKERS SYMPOSIUM

Perspectives from Law and Social Psychology

Introduction

James A. Fanto[†]

Here it is, almost three years after the fall of Enron, and the trials of some of the top executives involved in the corporate scandals are still proceeding or yet to begin. All too often the same pattern emerges. Significant senior executives, like a company's chief financial officer (CFO) and underlings, plead guilty to the misdeeds that brought down a firm and then act as government witnesses against the chief executive officer (CEO). The CEO resists vigorously, with the best defense counsel that money can buy, alleging that the scandal was solely the work of the CFO and his unscrupulous cohorts. In each scandal, the debate in the courtroom and the business press is about who is the *individual* ultimately responsible for the scandal. Generally, if a group is singled out in the discussion at all, it is the corporation's board of directors. But the board is not regarded as central to the scandal, except in a

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[†] Professor, Brooklyn Law School. I am grateful to Gail Pesyna and the Alfred P. Sloan Foundation, and Dean Joan Wexler of the Law School, for their support of the conference.

kind of negative manner, as being too inactive and indifferent in its oversight to have detected the misbehavior.

Examples abound. The drama of the responsibility for WorldCom's demise has just played out in court in a trial pitting its former CEO Bernie Ebbers (who was found guilty on numerous charges) against its former CFO Scott Sullivan (who has already pleaded guilty to securities fraud) as the prime mover in the fraud.¹ In another courtroom, former HealthSouth CEO Richard Scrushy is defending himself against fraud charges, with the chief opposing witnesses being the former CFOs (who all have pleaded guilty to securities fraud).² Kenneth Lay, former Chairman and CEO, and Jeffrey Skilling, former CEO, of Enron, have yet to come to trial.³ Arrayed against them will be the notorious Andrew Fastow, former CFO, and a host of lesser executives, who have all entered into plea agreements with the government. For the most part, board members of these companies (other than inside board members) have not been criminally charged, but are the subject of civil suits on account of their inattention that allowed the scandals to go on for so long.⁴

It is no surprise that the criminal trials are proceeding in this way, given that our criminal law and justice system are designed to determine an individual's guilt. Nor is it a surprise that the business media, which is in many cases really only a step up from the tabloids, strives to gain and maintain readers by emphasizing the personal stories behind the corporate scandals. Both of these reactions to the scandals reveal a fundamental human tendency to attribute complex misdeeds to individuals.⁵ This is the "bad apples" understanding of the corporate scandals or problems. This attribution error applies to complex positive outcomes as well.⁶ For example, the

¹ One can follow this saga in the pages of the Wall Street Journal. See, e.g., Almar Latour, et al., *Ebbers is Convicted in Massive Fraud*, WALL ST. J., Mar. 16, 2005, at A1.

² See, e.g., Dan Morse & Evelina Shmukler, *HealthSouth Ex-Treasurer Says He Found Fraud, Told Scrushy*, WALL ST. J., Feb. 17, 2005, at C4.

³ See *Start of Enron Trial Is Set for January '06*, WALL ST. J., Feb. 25, 2005, at C2.

⁴ See, e.g., Settlement Motion, *In re Enron Corp.*, et al. (No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 26, 2005)) (discussing settlement with outside directors of Enron).

⁵ This erroneous reasoning seems to be based on a general human tendency to simplify causation. See generally ROGER BROWN, SOCIAL PSYCHOLOGY 169-94 (2d ed. 1986) (discussing this human cognitive mistake).

⁶ See generally NASSIM N. TALEB, FOOLED BY RANDOMNESS (2001)

business media is only too ready to lionize corporate executives for the achievement of their firms: one has only to go back to the late 1990s to find article after article extolling Kenneth Lay and Bernie Ebbers. This is not to say that individuals matter for nothing in scandals or in success. But to focus on individuals blinds us to the complex causes of misbehavior (to consider the focus of this conference) and keeps us from making reforms that could prevent the recurrence of this misbehavior.

The principal purpose of the conference, "Corporate Misbehavior by Elite Decision-Makers: Perspectives from Law and Social Psychology," is to offer an alternative to the understanding that corporate misconduct and scandals are due to the work of a few "bad apples" among corporate executives and directors. From information available on the scandals, it appeared that inner circles of top executives, corporate advisors (accountants, bankers and lawyers) and board members formed coherent social structures that engaged in illegal or unethical behavior that destroyed firm value.⁷ A possible determinant of the scandals, in other words, was group, not individual, behavior. If this was the case, a number of interesting questions are posed and research avenues opened that could have important consequences for legal policy-making. What is perverse group behavior and what distinguishes it from positive group behavior? How did this group misbehavior arise in so many publicly-traded firms, which suggests that corporate governance structure contributed to it? How could individual members of these circles or groups engage in behavior that, on some levels, they knew was improper, but nevertheless accepted from a group perspective?

To answer these questions, it is necessary to turn to the social sciences, for one of the goals of social psychology and organizational theory is to understand and explain group behavior, including deviant group behavior. My co-organizer, Professor Larry Solan,⁸ and I thought that it would be useful to ask what researchers in these human sciences could tell legal scholars about the social psychological and other organizational causes of the corporate elite's misbehavior. We decided that the

(discussing tendency of individuals to take credit for random positive outcomes).

⁷ I develop this argument in greater detail in my article, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OREGON L. REV. 435 (2004).

⁸ Director of Brooklyn Law School's Center for the Study of Law, Language and Cognition, which sponsored the conference together with the Alfred P. Sloan Foundation.

best way to achieve this purpose was to bring together at a conference prominent social psychologists and organizational and management specialists to present and to discuss their theories and research about group misbehavior that could help explain the corporate scandals. We planned to have corporate law scholars, as discussants, comment upon the implications of these findings and research for policy making on the legal regulation of corporate governance and decision-making.

One goal of the conference was pragmatic: to find solutions to the misconduct of elite corporate decision makers from a social science perspective that legal policy makers, fixated on individuals as primary causes of the scandals, had overlooked. Yet the dialogue of conference participants was not addressed directly to policy makers as such, and it would have that pragmatic effect indirectly by contributing to a new direction in corporate legal scholarship. A complementary goal was then to stimulate and promote interactions and research between social psychologists and organizational theorists, on the one hand, and corporate scholars, on the other.

These interactions and possible joint research would help correct a tendency in the dominant direction of current corporate law scholarship to ignore group causes of corporate governance problems, which tendency has led to reforms that can only incompletely prevent corporate misbehavior. So much of this scholarship is grounded in the law and economics tradition that bases its policy prescriptions upon rational, self-interested economic actors.⁹ When faced with the corporate scandals, scholars in this tradition react in ways not unlike business reporters, members of Congress or federal prosecutors: they focus on the individual. For example, if a CEO, like Dennis Kozlowski, took too many benefits from his former company, Tyco International, it was because appropriately designed incentives had not been in place for all the corporate actors involved: his compensation package was not correctly keyed to his performance, and the members of the Tyco's board did not have adequate personal incentives to check his natural self-interested behavior. From this

⁹ There have been notable exceptions. We were fortunate to have at our conference as discussants, Donald Langevoort and Lynne Dallas, two legal scholars who have for some time used social science methods and research in their analysis of corporate and securities law issues and problems.

perspective, corporate scandals can be addressed only by reforms aimed at these individuals.¹⁰

Our focus in this conference, as would be our focus in the resulting research, is different. For us, individual behavior within groups can be understood as determined by group dynamics. This means more than that an individual is conscious of and affected by others, although this is certainly a part of the analysis. It is, rather, an account of how individuals as group members assume a social or group identity, which in turn influences their behavior when they are in the group. The influence comes when the group identity defines, among other things, the roles and appropriate behavior for individuals within the group. The study of group dynamics examines the formation of this group identity and the way in which it shapes thought, perception and behavior. The study should explain how groups with perverse purposes can form and how individuals participate in them and come to find their actions within the group entirely natural and proper, even though when viewed from a perspective outside the group, the individuals acknowledge them to be completely improper.

To encourage discussion as to the group nature of the misbehavior in the corporate scandals, we asked conference participants to consider the following related questions in making their presentations and preparing their articles:

1. Do corporate scandals reveal problems of group misbehavior among corporate elite decision-makers and advisors? Can social psychology and organizational theory help us identify the nature and causes of the problems?

2. Are there differences between the ways that people perceive themselves as individuals on the one hand and as members of groups on the other that can explain, at least in part, corporate misconduct?

3. Can corporate reformers do anything about these problems? Can social psychology and related human sciences offer reformers any guidance? In this connection, significant reforms aimed at elite corporate decision-makers and advisors have already occurred. From a social psychological perspective, how well-designed are they to address the group problems and how effective are they likely to be?

¹⁰ See, e.g., Michael Jensen, et al., *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them* (ECGI, Working Paper No. 44/2004, July 2004).

We think that each of the articles in this volume answers one or several of the above questions and together the articles represent the work that we wanted to foster and to share with a wide scholarly audience.

In his article, *The Cognitive and Social Psychology of Contagious Organizational Corruption*, Professor of Psychology John Darley appropriately begins the volume with a focus on the first group of questions by taking issue with the “bad apples” theory of corporate corruption, which, in his view, allows people to ignore the complex causes of corruption in corporations and other organizations. These causes include the phenomenon that Professor Darley has identified in his previous work: that corruption begins gradually, often with a small act that is morally ambiguous or barely improper, and proceeds by small steps until the corruption is monumental. This gradual descent into the immoral helps explain why so many ordinary individuals can participate in corruption. In a related point, Professor Darley observes that the acts leading to corporate corruption are the product not of moral deliberation but of quick, intuitive judgments, and these judgments are inherently self-interested (either for the individual, the group or both). He then discusses how these corrupt, self-interested acts spread or are imitated in an organization. This propagation occurs because those who are disturbed by the acts feel pressured to remain silent since the organization sends the message that the acts are acceptable. Even more significantly for the purposes of the conference, Professor Darley points out that group loyalty prevents employees from complaining about the progressively corrupt practices. The foundations of this loyalty, as discussed in more detail by Professor Hogg in his article, lie in an individual’s self-identification with the group, which transforms him or her into a group member with the group’s values.

The article, *Out of Touch: The CEO’s Role in Corporate Misbehavior*, by Professor of Organizational Behavior Linda Treviño, appropriately follows Professor Darley’s, because she argues that a CEO of a firm is critical for the development of its ethical culture, which can help prevent scandals and abuses. For her, the importance of the CEO appears first in the design and implementation of a firm ethics program: is it window dressing, or is the program formal, value-oriented and integrated into the life of the firm? These latter attributes make the ethics program effective, i.e., make employees more likely to behave ethically and report ethical violations because

they feel that ethics matters to the firm and the firm will support them and will punish ethical violators. She observes that the CEO must also foster an ethical culture informally, for the CEO's everyday behavior (which employees observe) reinforces the firm's formal systems. The CEO does this by providing a visible example of a moral individual (one who personally cares about ethics) and a moral manager (one who shows in his or her management that ethics matters). Professor Treviño further argues that leaders must make their ethical decisions visible, provided that they are otherwise ethical persons and not hypocrites, because, unfortunately, there is a large social distance between the CEO and most employees. Professor Treviño then uses this distance also to explain why many CEOs fail to understand the ethical problems in their organization. Situated at the top of the firm, insulated from much of its activities and yet personally identified with it, a CEO cannot see many of its ethical problems and tends to adopt a rosy view of the organization. She also points out that because CEOs socialize almost exclusively with others of similar status they are unaware of issues and problems at the ordinary employee level.

Then, in his comment on Professor Darley's and Professor Treviño's articles, entitled *Discussing Corporate Misbehavior*, Professor of Law Daniel Greenwood points to the disturbing outcome in U.S. corporate law: the narrowing of the purposes of the large complex organization, that is the public corporation, to a maximization of shareholder wealth. He insightfully observes that, while enormous CEO pay has been justified by the need to motivate self-interested individuals to perform well, CEOs state that they have little connection to and awareness of the enterprise whenever they are accused of being responsible for a scandal. The outsized CEO compensation, he contends, thus has no justification in light of the CEO's great distance from other employees, especially since, as Professor Treviño shows, the CEO's example and connection with the firm are critical to the development of its ethical culture. Commenting on Professor Darley's article, Professor Greenwood emphasizes how it underscores the weakness of a corporate law that ignores the organizational complexity of firms. For Professor Greenwood, employees' pursuit of organizational goals and purposes, which, according to Darley, lead them into scandals, points to a contradiction lying at the heart of firms: the good for which individuals are asked to sacrifice their time and even their liberty is only the

self-interest of the firm, which is an impoverished parody of morality and of the value of the common good and which, paradoxically, ends up driving the firm out of business. Professor Greenwood concludes his comment by setting forth broad ideas for reforms that might reintroduce values into corporate law debates.

Professor of Social Psychology Michael Hogg squarely addresses, in his article, *Social Identity and Misuse of Power: The Dark Side of Leadership*, the second conference question (Are there differences in social and individual self-conceptions?) by using social identity theory (of which he is a major exponent) to explain group features that could have led to the corporate scandals. Professor Hogg initially sets forth the basics of social identity theory, which explains how individuals categorize others and themselves in terms of their identity in significant groups (such as work groups), i.e., they “depersonalize” themselves and others in their group membership. He then describes how leadership makes sense in this theory: a leader is a prototypical member of a group, yet also with the ability to experiment in his or her behavior so as to lead the group in new directions (a member with “charisma”). But this account points to potential group problems. As Professor Hogg explains, if group norms defining group and individual member behavior do not include ethics, then group members, especially leaders, are likely to act unethically as part of the group. Moreover, given the deference of group members, the leader can move the group gradually towards unethical behavior. Indeed, as he explains, the leader can even use his or her status to begin to isolate himself or herself and a small coterie from the rest of the group (as demonstrated by CEOs in many scandal-ridden firms). Professor Hogg then introduces another important aspect of social identity theory, a group’s reduction of uncertainty, to explain unethical corporate behavior. He outlines a situation that can lead to scandals: individuals in corporations form groups with strong social identity and with powerful leaders because of the uncertainty of competitive corporate life. The leader and his or her minions may, in turn, become isolated in the organization and, if unchecked, they may lead it into corruption and disaster.

In their co-written piece, Professor of Organizational Behavior Rakesh Khurana and graduate student Katharina Pick pose the individual vs. the group problem in contending that a board of directors cannot be understood only as a

collection of individuals. They first survey the understanding of the board under the dominant agency theory as a collection of individuals contracting with the firm and argue that the agency perspective does not capture the experience of board members or the facts about the corporate scandals. (But they warn that agency theory may create boardroom reality by encouraging board members to think of themselves as only self-interested individuals.) In an approach similar to those of Professor Darley and Hogg, they then discuss the social attributes of boards that make them similar to other groups and that may have led to the scandals. Boards act cohesively pursuant to well understood group norms, but, as Khurana and Pick explain, these norms can prevent directors from questioning critically CEOs and other senior executives, which would have revealed problems in firms. They also point out that board norms are long lasting and difficult to change, and that these norms reinforce board members' conformity to the group's perspective and generally discourage dissent of any kind. The passivity is understandable in situations of uncertainty, which is usually that of a board, where experts, such as senior executives, offer authoritative views and where non-expert board members are discouraged from ever becoming active in raising issues. Khurana and Pick make the interesting additional observation that board norms of one firm are often similar to the norms of other firms, since board members constitute a small, closed population in U.S. society. Moreover, the authors observe that, like all groups, boards have developed routines for dealing with their tasks, which routines, occasionally, enable them to overlook critical issues and information (such as the Enron board's routine approval of conflict of interest transactions). Khurana and Pick conclude their article, however, with an optimistic observation about the social nature of boards: increasingly norms of professionalism for board members are being developed, which may improve overall board performance and board norms.

In a response to the third set of questions about the contribution of the social sciences to corporate reform, Professor of Psychology Tom Tyler poses the question how businesses with well-meaning executives can achieve employee compliance with laws and ethical norms. At the beginning of his article, *Promoting Employee Policy Adherence and Rule Following in Work Settings: The Value of Self-regulatory Approaches*, he contrasts two methods of firm ethical governance: the "command and control" model, which relies on

external sanctions and rewards, with the “self-regulatory” model, which relies on internal employee motivations. Professor Tyler points out that businesses have traditionally used the “command and control” model, which ensures compliance with policies through incentives and sanctions but which is costly and not particularly effective. The self-regulatory model, on the other hand, ensures compliance by activating in work settings employees’ own ethical values, which in turn legitimates the organization’s values and rules. Professor Tyler discusses the empirical support for the self-regulatory model, which also demonstrates its utility and effectiveness in business settings. He next explains that a firm can best activate employees’ ethical values by having employees perceive that fair procedures are used in firm decision-making and other workplace events. His message here is that employees feel comfortable about working for an organization and find its rules to be legitimate if they perceive that it treats them fairly. This finding gives companies a clear guideline: if they want employees to comply with a company’s rules and otherwise to act ethically, the company must establish fair procedures for workplace decisions. This raises the question of what constitutes a fair procedure, and Professor Tyler offers definitions and examples involving four important procedural components: the quality of decision-making, the quality of peoples’ treatment by organizational authorities, the rules of the organization and an employee’s experience with a supervisor(s).

In his article, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, Professor of Law Lawrence Mitchell argues that the reform focus of improving the independence and monitoring ability of corporate boards misses an important origin of the corporate scandals in the power of CEOs and other senior executives. To explain this power, Professor Mitchell uses the theory of “structural holes” from economic sociology, which posits gaps between networks of individuals and groups and the importance and advantages that accrue to people who can fill the gaps. Unlike classical economics, the theory sees the actor as a social creature, i.e., a part of various social networks. After discussing the theory and situating it in economic and sociological discourse, he uses it to point to the gaps in the governance of public corporations that corporate actors can use opportunistically and that reforms should (but don’t) address. For Professor Mitchell, the theory suggests that the current

effort to control CEO power by emphasizing boards with independent directors may have the opposite result, for in firms with these boards the CEO alone would fill the structural holes of information about the corporation for the directors (as opposed to the situation of a board with inside directors who would be part of other informational networks in the corporation). Even more interestingly, Professor Mitchell uses the theory to explain scandals involving senior executives, other than the CEO, because the CEO, consciously or not, may allow structural holes to develop beneath him in the organization, which are filled by senior executives who could engage in unscrupulous behavior (if so inclined) and which give the CEO "deniability." Professor Mitchell further justifies his application of the theory by pointing to the movement in business organization from hierarchical to flatter organizational structures. The latter allow for more structural holes, because more managers report to the CEO, and thus more possibilities of CEO or senior executive opportunism (depending upon who fills the holes). He thus argues that typical reforms aimed exclusively at enhancing the board's monitoring ability miss structural holes below the board as an important determinant of the corporate scandals.

Although she was not a presenter at the conference, Professor of Philosophy Margaret Gilbert offers her views on the subject of corporate misbehavior in her paper *Corporate Misbehavior and Corporate Values*. As is customary in philosophical discourse, she gives precision to the concepts of group beliefs and group values, to distinguish them from their personal counterparts and to emphasize their strength (through a group member's "commitment" to these beliefs and values) in crowding out conflicting individual beliefs and values. As she argues, "collective beliefs, values and goals are apt to induce people to disguise their contrary opinions—however morally perspicacious—and to abstain from any active effort at their diffusion." She joins with Professors Treviño and Tyler in asserting that it is critical to prevent corporate scandals for a firm to make moral values a part of its group beliefs.

These articles clearly fulfill the goal of our conference of promoting new avenues of scholarly research on business firms and their pathologies. At the end of the conference, moreover, its participants met in a planning session to discuss ways of promoting research between organizational theorists and social psychologists, on the one hand, and corporate scholars, on the

other. This session led to the following projects: In the near future, there will be launched an electronic journal to be published by the Social Science Research Network entitled "Business Associations and Financial Law: An Interdisciplinary Journal," which is designed to circulate papers in the business law area with a social science focus. Participants in the conference as well as other interested scholars are also working to create a model interdisciplinary course with readings from the social sciences and the law. We hope that these will be the first of many collaborative projects between social scientists and legal scholars, and that the projects may improve legal policy-making on the regulation of corporations and financial institutions.