Introduction: How to Profit from the Scandals

The purpose of this short book is to suggest that the business community can turn the scandals of recent years to good use, both for business itself and for the larger society. The scandals have shocked the business sector into realizing that something is seriously wrong with its current practice, and that to regain the trust of the American people it must institute far-reaching changes—or else suffer punitive reforms imposed by government. The most badly needed changes are ethical in character, and taken together they represent a new stage in the evolution of market capitalism.

My main argument in the book is that the time has come for market capitalism in the United States to advance to a new stage of enlightened self-interest. American business needs to develop a new ethic—a coherent set of social norms—both to counteract the forces leading to the scandals and to meet the challenges of the global economy that call upon business to take on many new responsibilities. The good news is that some leading corporations are moving in this direction. The bad news is that most are not.

The vast changes taking place in the global economy make it essential that we evolve to a new stage of market capitalism. Coincidentally, to put the scandals behind us we also need a higher standard of ethical norms. The same set of norms, one that I am calling "stewardship ethics," can serve both purposes. Many years ago, the philosopher Alfred North Whitehead observed that "a great society is a society in which its men of business think greatly of their functions." Whitehead believed that business leaders should broaden the orbit of their concerns from those of their individual company or industry to the society at large. I would like to add that a great society is one in which its business, political, and civic leaders (men *and* women) exercise their leadership within a frame of stewardship ethics.

Once Again, a Perfect Storm

The proliferation of recent business scandals has created a wave of public mistrust of corporate America. The mistrust, in turn, has led to onerous new regulations, to the humiliation and imprisonment of once-admired business leaders, and to an automatic presupposition that the business community is guilty of bad faith. Nowadays, few business leaders are given the benefit of the doubt when their companies run into difficulties. The assumption is, "They must have done something wrong."

The scandals cover a wide swath of corporate behavior. They range from gross criminality (Enron, WorldCom, Tyco, Adelphia), to the petty legal mistakes of Martha Stewart, to the steep fines and embarrassing revelations that have ensnared

some of the nation's premier companies, such as Fannie Mae, Citigroup, Merck, AIG, Boeing, Shell, JP Morgan/Chase, and Marsh and McLellan.

Why is our culture suddenly confronted with so much corporate wrongdoing? What are the forces giving rise to the scandals?

As time passes and we gain perspective on the first megascandal—the 2001 Enron/Arthur Andersen implosion—the causes for the business scandals begin to grow clearer. The scandals are not the result of a national outburst of greed, contempt for the law, the arrogance of power, or a breakdown in corporate governance, though elements of each are present. The main cause is an extraordinary convergence of three trends, the sort of rare phenomenon that generates what people like to call "a perfect storm."

One trend is deregulation. The rage for deregulation that dominated the 1980s and 1990s had many unintended effects. By removing the legal restrictions that prevent blatant conflicts of interest, deregulation tempted some of the gatekeeper guardians of the public interest to sacrifice the principles of their professions for their own economic gain. Deregulation had the perverse consequence of transforming the gatekeepers—the accounting firms, the investment bankers, the business law firms, the regulatory agencies—into enablers. Instead of saying a firm "no" to questionable business initiatives, many of these supposed watchdogs (like the once highly regarded accounting firm, Arthur Andersen) said instead, "Here's how you can do it and get away with it."

Converging with deregulation is the second trend—the practice of linking the richest part of CEO compensation to the vagaries of the stock market. Tying executive incentives to the price of the company's stock has become common practice. The intention is to align the interests of a company's managers more closely with those of its owners—the company's shareholders. This is the most popular way the economic doctrine known as "shareholder value" has been implemented. In practice, however, rewarding executives with stock options potentially worth tens of millions of dollars on top of rich salaries and bonuses has proven to be a debasement of the theory. With such huge sums of money at stake, the company's executives are sorely tempted to take questionable shortcuts, or even to cheat. The pressures on a CEO to put the short-term price of his company's shares ahead of the long-term interests of the company, its employees, and the society as a whole become almost irresistible.

The third and more intangible trend is the steady importation of social norms from the larger culture into corporate life. Ironically, American business, whose deepest tradition is rooted in the ethic of enlightened self-interest, now finds itself caught up in a frenzy of *un*enlightened self-interest. Traditional enlightened self-interest led business executives to search for strategies that benefited others as well as themselves. But the cultural norms of recent years celebrate an ethic of winning for oneself—a zero-sum social Darwinian conception of winning under which if I win, you lose. Fear of the consequences of losing is part of this outlook, as is an offhand attitude toward "gaming the system." Many of today's business executives consider it a challenge—and fun—to find ways to manipulate the system for their own personal benefit.

The convergence of these social norms from the general culture with the business norms of deregulation and the perversion of shareholder value creates conditions for the perfect storm. Combining these forces invents a machine for scandal. Their convergence made the scandals almost inevitable.

What Is the Cure?

It would be a great relief to say that now, in the light of our experience with so many scandals, our business sector is finally taking the right medicine to cure itself. But unfortunately, this is far from the case. The medicine we *are* taking—a heavy dose of legal and regulatory actions—may be necessary, but it is far from sufficient.

Laws and regulations by themselves do not ensure compliance. One of the most prominent features of the scandals is gaming the system—finding clever ways of circumventing the rules and regulations. Accounting and financial management firms seek ways to "smooth" earnings and get around strict accounting standards. Law firms quickly come to understand that legal counsel advising against a questionable course of action wins them scant business or applause. A law practice prospers only when its attorneys are able to advise their clients how they can maneuver their way around the law. Without a normative climate that encourages compliance with laws and regulations, clever people will be tempted to skate on ever-thinner ice—and risk falling through it.

History shows that you cannot fight bad norms solely with laws. The failure of Prohibition in the 1920s—the doomed effort to use the law to prevent people from consuming alcoholic beverages—is only one case in point. The recent scandals present us with a lethal combination of bad norms and bad regulations. The key to successful reform is to combine regulations and norms in such a way that they mutually support each other in encouraging companies (and gatekeepers) to do the right things, not the wrong ones.

Sometimes we do need to resort to legal remedies. Some scandals feature serious violations of the law calling for serious punishment. Few would argue that Bernie Ebbers, the founder of WorldCom, does not deserve his prison term. But most of the scandals—the rip-offs, the conflicts of interest, the "creative accounting"—constitute ethical rather than criminal violations. Our society is already too long on legal approaches to problems and too short on ethical ones. The legal/regulatory side of business, however important, can neither fully account for the scandals nor prevent them in the future. Only a transformation of ethical norms, supported by the right kind of regulation, can do so.

The concept of norms plays a major role in this book. Norms are social values—the unwritten rules that dictate what sorts of behavior are acceptable or unacceptable. Norms refer both to standards for acceptable behavior and to punishments meted out to those who violate the standards. Norms are often specific to particular social roles or subcultures. Every individual is subject to a wide variety of norms that overlap and sometimes conflict. In general, though, norms tend to cohere. A coherent set of norms constitutes an ethic: a generalized way of understanding one's relation to others in a tightly organized polity and society.

My focus on norms is not intended to detract from the importance of the legal/regulatory side of business. But just tightening the law, throwing some high level executives in jail, and changing the governance rules of boards of directors, however desirable or necessary, will not be sufficient to raise the level of corporate ethics. To counteract the scandals, the normative side of business must receive priority at the same time that the legal side is being strengthened.

My emphasis on norms differentiates this book from most recent writing on the corporation. Over the past forty years much scholarly work on the corporate sector has focused

on corporate governance—the legal and regulatory mechanisms for managing the problems that arise from the conflicting interests of various stakeholders, especially the separation of corporate ownership and control. Business corporations have always stirred up conflict and legal dispute because the stakes are so high. The stakes concern money and power and influence and issues of control—things people fight about. In democracies, the law often settles the fights. Scholars therefore write about contracts and regulations and legal disputes. Recently, some noted scholars have added politics to the mix, because decisions about what gets regulated and enforced are often the product of political struggle. As the political scientist Peter Gourevitch observes: "It is no wonder . . . that corporate governance provokes conflict. . . . Anything that shapes wealth, opportunities, stability, and corruption is sure to attract the concerns of the powerful and provoke the anxiety of the weak. Everyone has a stake in the corporate governance system, and everyone has an interest in how it is structured. . . . We believe that corporate governance structures are fundamentally the result of political decisions."[1]

But the law is a blunt instrument, especially when it is the product of political negotiation, and there is only so much that government can do to influence corporate behavior. Efforts to combat ethical shortcomings with legal restrictions emphasize blame, constraints, fines, jail sentences, and other negativities. If you want positive results, you need to give people a positive basis for trust and respect and an ethical vision to live by, not merely severe punishments for misdeeds. The law can't inspire the far-sighted corporate leadership that is so badly needed. It can't enhance the contribution that the business sector can and should make to the larger society. To achieve these broader goals, we need to look to the cultural and human side of corporate life—to the values and motivations and belief systems of people.

There is nothing novel about this emphasis. Way back in 1932, in their classic work on the corporation, Adolf Berle and Gardiner Means spoke of their fear that "power, prestige or the gratification of professional zeal" might distract managers from their main task of making money for the company's shareholders.[2] Add to these such newer temptations as the sheer magnitude of the rewards for cheating (tens of millions of dollars) and the powerful rationalization that as long as you aren't breaking the law, you aren't doing anything wrong. These are not legal matters; they are matters of values and ethical norms.

Business scandals constitute just one symptom of normative confusion in the nation. There are countless others—the troubles of the Catholic Church, the blind spots of the Congress in budget making, the corruptions of state and city government, the muddled priorities of the American Red Cross, even baseball's steroid scandals.

I have chosen to focus on ethical confusion in the business sector for one reason above all others: I believe that the chances for success are better here than in other spheres of American life, and that a high standard of ethical clarity in the business sector will help to dispel moral confusion in the culture at large. In our country, the business sector occupies a role of centrality and prestige. As the source of our economic well-being, its health and vitality are immensely important to Americans. Just yesterday, CEOs like G.E.'s former chairman, Jack Welch, Chrysler's Lee Iacocca, and Intel's Robert Noyce were culture heroes, models to emulate. If business gets its ethical act together, it may well serve as a model and inspiration for others to do the same.

The four-hundred-year history of the limited liability corporation is replete with scandals, reforms, abuses, midcourse

corrections, and redirected energies. The present moment gives the business sector a splendid opportunity to transform scandal, embarrassment, and mounting public mistrust into revitalized ethical standards that will be good for business, good for the nation, and good for the world.

Capitalism has always been a work in progress, never a finished product. Marxists have always underestimated the flexibility of capitalism and its ability to adapt to changing circumstances. The father of modern capitalism in the eighteenth century, Adam Smith, was a moral philosopher, attributing to human nature an inborn empathy for others. It was this presupposition that gave credibility to his master concept of "the invisible hand," which made the economic pursuit of self-interest compatible with the interests of the larger society in what Smith called a "society of perfect liberty."[3] Capitalism has always aligned itself with this concept of enlightened self-interest. The key question—the one that dominates this book—is how best to apply it to our own historical era.

Potentially, our nation's prospects for upgrading corporate ethical standards are quite good, for two reasons. One is rising expectations from outside the business sector; the other is a growing urge for reform within the business sector itself.

Business leaders are growing more aware that new expectations are in the air. In the words of Samuel Palmisano, CEO of IBM: "All businesses today face a new reality. . . . Businesses now operate in an environment in which long-term societal concerns—in areas from diversity to equal opportunity, the environment and workforce policies—have been raised to the same level of public expectation as accounting practices and financial performances."[4]

In a statement published in the April 7, 2005, *New York Review of Books,* Lee Scott, the CEO of Wal-Mart Stores, defended the giant retailer against its critics. Wal-Mart is a gigantic enterprise: it employs a million people; in 2004 its sales exceeded $260 billion. The final paragraph of Scott's two-page ad illustrates a business awakening that is still at a very early stage. Scott writes: "To be honest, most of us at Wal-Mart have been so busy minding the store that the way our critics have tried to turn us into a political symbol has taken us by surprise. But one thing we've learned from our critics . . . is that Wal-Mart's size and industry leadership mean that *people expect more from us. They're right to, and when it comes to playing our part . . . we intend to deliver*" (emphasis added).

Cynics may sneer at Wal-Mart's newfound religion and dismiss it as mere public relations—empty rhetoric covering hard-core hypocrisy. And so, indeed, it may turn out to be. But it may also turn out to be a far more benign phenomenon, a sign of responsiveness to changing expectations. Typically, responsiveness starts with a change in corporate attitudes at the leadership level, followed eventually by a significant change in corporate behavior.

We *do* expect more from the giant multinational corporations of our era. Under the right conditions they *can* deliver. We look to Toyota and other car manufacturers to lessen our energy dependence; BP, Shell, and other oil companies to search for alternative fuels and practical remedies to the threat of climate change; G.E., Procter and Gamble, and other giant international companies to open new markets in developing nations; General Motors and other large employers to help resolve the health care crisis; Citigroup and other financial institutions to address the capital needs of poor people in developing nations; Microsoft and other technology companies to digitize the world; the corporate sector in general to assist poor nations in securing the training, education, and resource management they need to enter the global economy.

The challenge to business is, in part, a matter of responding to these heightened expectations. Only a small number of businesses are currently responding well to the challenge. Many more are capable of responding skillfully and effectively.

Ethical Stirrings within Business

My decades of research on American attitudes and values have led me to the conclusion that existing standards of business ethics are too weak to stop the scandals and restore trust. Our corporations need to adopt a higher standard of ethics.

The corporations I have worked with personally (either as a board director or consultant) operate at several levels of ethical standards. The lowest level is one in which the legal department is consulted to make sure that the company is not breaking any laws, or at least none whose violations might get them caught. The next level up is the ability of company policies and actions "to pass the smell test"—a term of art in business circles to refer to proposals that meet minimum legal requirements but fail to adhere to the society's conventional ethical standards. In many companies, there is at least one board director who can be counted on to say in response to a fishy-sounding proposal, "Well, maybe it's legal, but it doesn't pass the smell test." More than half of the companies I have worked with use the smell test as their everyday ethical working guide to action.

Figure 1 illustrates the hierarchy of current ethical standards in the business sector. The lower two-thirds of the pyramid reflects the dominant mores—staying within the law and passing the smell test. The top one-third symbolizes a higher standard of ethical norms.

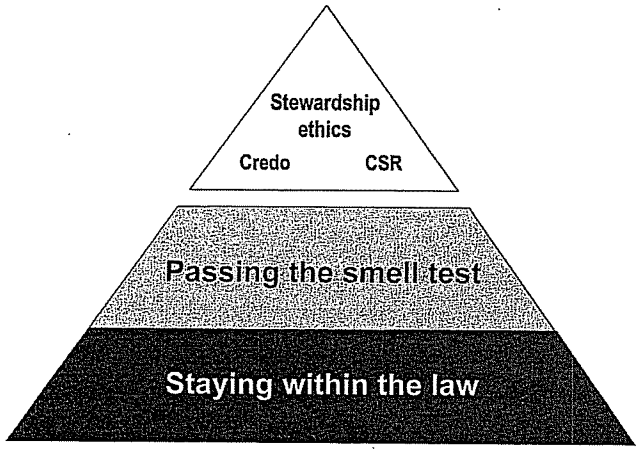

Figure 1. The hierarchy of ethical standards

In the wake of the business scandals, increasing numbers of companies are seeking to achieve the higher standard represented by the top third of the pyramid. The most traditional way of pursuing that goal is by way of a company credo—often articulated by the company's founder and maintained by his successors. Some companies faithfully live by such credos and internalize them within and throughout the company. Enron, which famously touted its high-minded credo, has cast a shadow over the practice of publicizing company credos. But companies like Johnson and Johnson with long-established credos see Enron as a symptom of flagrant hypocrisy and stick by their own tradition.

The Corporate Social Responsibility movement (CSR) represents a more recent form of striving toward higher ethical standards. For a variety of reasons spelled out in subsequent chapters, CSR has not caught on in corporate circles as

well as its advocates hoped it would. The early advocates of CSR in the 1960s, 1970s, and 1980s came mostly from the nonbusiness segments of society. They spoke in the off-putting accent of moral superiority, and they betrayed ignorance of business realities, making demands that threatened to weaken the competitive positions of companies. Moreover, their tactics were often self-defeating: they would target the most responsive companies, returning with new demands to the same company again and again, causing these companies to feel like fools for responding so readily.

CSR's biggest liability was that its early proponents had a deeply ambivalent attitude toward corporate profits. Many of them wanted to see companies that followed CSR principles make a profit, but profit making was a secondary consideration, and for some barely an afterthought. To put it mildly, this tendency limited CSR's appeal to the corporate sector.

In this earlier period of CSR's existence, the philanthropic activities of most companies consisted of writing a check (sometimes quite a fat one, as in Mobil's sponsorship of *Masterpiece Theatre*). The marketing guru Philip Kotler points out that CSR evolved into a more businesslike enterprise in the 1990s.[5] Many companies that had avoided causes related to their businesses, to avoid appearing to be self-serving, did a 180-degree turn. They focused their involvement on activities of concern to their employees and customers and related to their core businesses—for example, Shell started to cooperate with environmental groups, and Dell began a program of recycling of computers at no cost to purchasers.

The concept of stewardship ethics that I develop in this book puts more emphasis on profit than do most CSR initiatives. My conception of stewardship ethics retains profit making as a top corporate priority. But it takes the further position that, with sufficient effort and the right sort of strategic analysis, the business sector can do a far better job than it has in reconciling profit making with taking better care of its employees, its customers, its community, and the larger society. As CSR evolves, it is likely to overlap with stewardship ethics more than it has in the past. But the emphases of the two codes of ethics are different. With its roots outside the business sector, the interests of CSR will naturally focus on the social good that corporations can do, irrespective of their profitability; stewardship ethics will focus on decisions that advance the good of the company. When General Motors had a choice years ago to invest its capital either in acquiring Hummer or in making more fuel-efficient vehicles, it chose Hummer. In retrospect, it would have been far better off today if it had made the business (and existential) choice that devotion to stewardship ethics would have dictated.

There is nothing novel about the concept of stewardship. The word is familiar to almost everyone, though it has a variety of meanings. Many businesses trot it out around Christmastime, as if it were too special to pursue every day. Churchgoers sometimes wince at the mention of stewardship because it usually means "give money now." Stewardship is also used frequently in discussions of the environment, where it has the literal and religious connotation of caring for, restoring, and improving the water, air, forests, oceans, land, animal habitats, and other parts of the physical environment so essential to nature's well-being.

In this book, I use the term *stewardship ethics* to convey the commitment to care for one's institution and those it serves in a manner that responds to a higher level of expectations. In the chapters that follow, I elaborate how the ethical commitments of corporate cultures are directly related to the social,

political, and economic structures of the larger society. If our corporations can upgrade their ethical norms to the level of stewardship ethics, this achievement will also strengthen the ethical values of our society.

It is prudent to avoid ranking company credos, CSR, and stewardship ethics in hierarchical order of ethical standards. Each has its own strengths and limitations. But whether through taking company credos more seriously, or through accepting CSR principles, or through adopting stewardship ethics (as I propose in this book), it is the space in the pyramid above the smell test that is attracting the attention of more and more corporations.

The Wider Context

If our society expects business to be more engaged in the larger problems and concerns of our times, we need to understand what those concerns are, especially ones that are unfamiliar and even startling. Though we are in only its first decade, the twenty-first century is already shaping up as strikingly different from the previous one. In the twentieth century, nation-states with highly organized military forces fought with one another over issues of balance of power, colonialism, and territory. The major ideological struggle was Marxism versus capitalism.[6]

The tensions and struggles of the current century have a far different character. Colonialism is mostly past. Balance of power and territory have grown less important, ideology more important. But unlike in the past, ideology is not mainly about capitalism and economics. Instead, it is about religion, culture, and social morality. The West is engaged in a bitter ideological struggle with Islamic fundamentalism that focuses on essential values and cuts across national boundaries.

Western leaders have made a conscious effort to avoid framing the struggle as a religious war or a clash of civilizations. But its religious fervor and intensity are hard to avoid. This ideological/religious struggle is in turn taking place in a global economy that creates ever-larger gaps between have and have-not nations—at the same time that it opens up new opportunities for the have-nots to join the haves. The several billion people in the world who live on less than two dollars a day want to join the club of prosperous market economies. Thanks to technology and advances in market capitalism, the means actually exist for them to do so—a shift that will give a giant boost to world economic growth. Technology is helping people to live longer. It is making communication easier. And it shows promise of developing technological fixes for some of the globe's most bewildering problems, such as adapting to climate change, finding substitutes for fossil fuels as sources of energy, and creating abundant supplies of fresh water and food.

In the midst of these varied global changes, the American public has become absorbed in, and distracted by, a struggle to rediscover its own ethical bearings. A muddy ethical confusion pervades the culture, and Americans increasingly turn to religion for guidance. Opinion polls show that Americans are turning to religion in their quest to find firmer ethical ground on which to stand.[7] The United States' cultural revolution, initiated in the 1960s and 1970s, made our society more tolerant, more pluralistic, and freer. But these positive developments have had unintended consequences. They have led to a disorienting moral relativism and difficulty in distinguishing between right and wrong.

On the political front, conservatives, liberals, and moderates all worry about the loss of moral rectitude in our society. Conservatives focus on family-linked issues like abortion, gay

marriage, and a morally toxic environment in which to bring up children. The more liberal-minded have a different set of outrages: the ever-expanding gap between rich and poor, threats to the environment, corporate executives enriching themselves by ripping off others, and the ethics of a might-makes-right foreign policy that alienates traditional allies and engenders fear and hatred of the United States in other parts of the world.

Perhaps the clearest sign of ethical confusion in the nation is the proliferation of so-called unsustainable trends—the increasing din about the lack of "sustainability" of our present policies. Within the space of a week or so I have heard or read that . . .

- Our Social Security system is unsustainable
- The rising tide of health care costs is unsustainable
- Our swelling trade deficit with other nations is unsustainable
- The trend toward a weaker dollar is unsustainable
- Our energy policies and dependence on Middle East oil are unsustainable
- The widening gap in our society between rich and poor is unsustainable
- Our frayed relations with our traditional allies are unsustainable
- Our policy of stonewalling the efforts of other nations to do something about climate change, with its threat of global warming, is unsustainable
- The growing political polarization between the "red states" and the "blue states" is unsustainable
- Our policies toward the Muslim world, with their implicit threat of igniting a religious war, are unsustainable

- The poor performance of our students on math tests in relation to students from other nations is unsustainable

Our nation rose to greatness because we are a resourceful people blessed with a practical-minded, pragmatic, nonideological political culture—and a gift for problem solving rather than theorizing. There is nothing inherently overwhelming about these so-called unsustainable trends if we confront them with our customary pragmatism, practicality, and core American values.

What is most depressing about the current political scene is that we seem to have abandoned our habit of facing issues head-on. We are flooded with problems to which we are unresponsive. In place of wise and responsible leadership, we get denial and avoidance, pandering to wishful thinking, ideological conviction posing as thought, short term-itis, polarized politics, a loss of moral compass, infatuation with technical fixes for nontechnical problems, mythical silver bullets, simple-minded sound bites. What a strange turn of destiny it is that when we most need our traditional practicality, we decide instead to overdose on superficiality, ideological willfulness, and inadequate solutions. Situations don't start out unsustainable; they become so when they fester for too long. The more we neglect them, the worse—and less sustainable—they become. Until and unless we regain our sense of ethical direction, our moral compass, we will not be able to cope with all the forms of unsustainability that confront us.

Throughout the nation, these varied concerns hover in the back of most people's minds as a vague and anxious-making suspicion that something has gone wrong in America, without a clear and cogent diagnosis of what it is.[8]

At first glance, these broader concerns may seem unrelated to the subject of this book—the quest for a new ethic for business. But a deeper look shows that they are directly relevant. The key question for the United States is what institutions are best equipped to address the key issues confronting the present century—the cultural/ideological war with Islamic fundamentalism, the need for sustainable development, climate change, the expansion of market economies to the developing world, the harnessing of technology to achieve energy independence, and so on. The assumption that our government and our educational and religious institutions can and will address these issues is unrealistic if we assume that government can do what needs to be done without heavy reliance on the resources of the business sector.

To open the developing world to market economies we need the direct engagement of corporate America. To create customers for our products, we need to support large-scale efforts to raise education levels throughout the globe. To grope our way toward energy independence, to deal with climate change, to raise the level of global health and combat infectious diseases, to create new opportunities for women—for these and other vital tasks we need the participation and support of our powerful multinational corporations. Corporate America may also prove essential to prevailing in our struggle with Islamic fundamentalism. To win the support of Muslim moderates and isolate the extremists, we may need farsighted economic programs, not primary reliance on military force.

The late Roberto Goizueta, former CEO of the Coca-Cola Company, put the point pithily: "While we were once perceived as simply providing services, selling products and employing people, business now shares in much of the responsibility for our global quality of life."[9] This is the heart and soul of the next stage of market capitalism. The right kind of enlightened self-interest for the new century is the one that companies like Coca-Cola, Procter and Gamble, G.E., Starbucks, Shell, and others are moving toward: a broader engagement in solving our most obdurate global challenges.

Part I
Framing the Problem