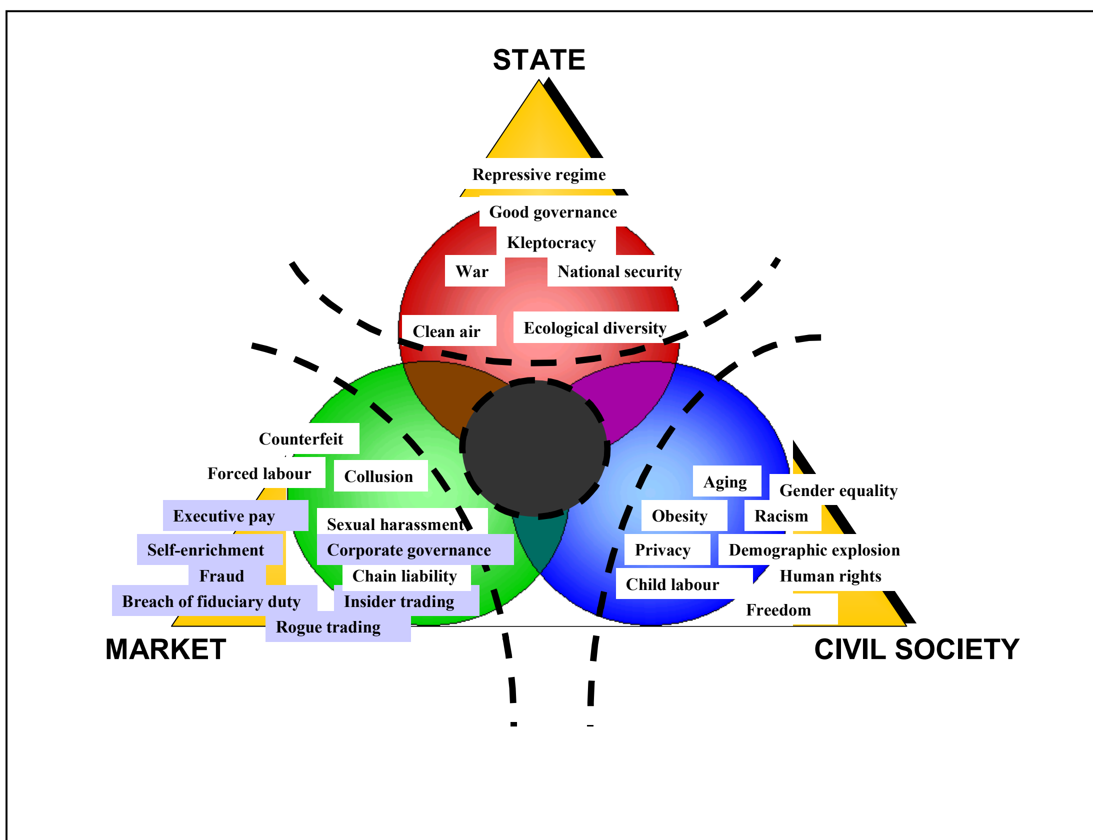
SUSTAINABILITY CHALLENGE # 6:
FIDUCIARY DUTIES

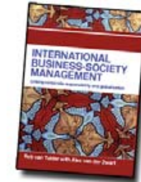
Primary Responsibility Issues



1. Introduction: stretching personal duties[1]

For corporate managers public responsibility is embedded in the principle of **'fiduciary duty'**, the obligation to act in the best interest of the owners of the company. Fiduciary

[1] This dossier was written by Rob van Tulder. It elaborates one theme that has been addressed in chapter 10 (on 'The Stakes – Firms part of the problem or part of the Solution') of the book "International Business-Society Management" (Van Tulder with Van der Zwart, 2006, Routledge). References in the text to Figures, Chapters and Tables, refer to the original book. The dossier is intended to illustrate how this particular issue can be approached by both scientists and practitioners. Last updated: March 2006.



duty in Anglo-Saxon countries mainly relates to the interests of the shareholders, whilst in non-Anglo-Saxon countries other stakeholders such as employees are usually taken into account as well. The discussion on the fiduciary duty of managers became more acute in the second half of the 1990s following a large number of corporate 'scandals' involving top executives of big corporations. As a result the legitimacy of businesses decreased considerably.[2] Table 1 lists prominent cases in the OECD region for the 1998-2004 period. Alleged 'scandals' on insider trading, executive compensation, the bending of accountancy rules, self-enrichment through excessive bonusses, fraud and corruption left hardly any country untouched.

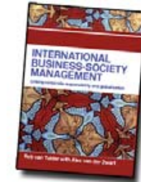
Table 1 Corporate 'scandals' involving top executives* of leading companies, 1998-2005

INSIDER TRADING	***FRAUD/ CORRUPTION***	***ACCOUNTANCY RULES' BENDING***	***EXCESSIVE EXECUTIVE PAYMENTS***
Brink# (World Online), Boonstra## (Philips), Stewart@, Waksal@ (Imclone), Messier# (Homestore, AOL Time Warner), Rankin*+ (RBC Dominion Securities)	Parmalat (Tanzi@, Tonna@, Bassi+); Worldcom (Ebbers@#, Sullivan@)~ SK Group (Chey Tae-won@, Son Kil-Seung) Hyundai (Chun Mong-Hun+); Enron (Lay#@) First Allied (Rusnak)&, National Australia Bank** (Cicutto#**), Sumitomo bank (Hamanaka)** China Construction Bank/Central Bankε Arthur Andersen~, J.P.Morgan++, Citigroup++, Merrill Lynch++ Boeing (Condit#), Coca-Cola, Joekos (Chodorkovski, Lebedev@), Elf (Le Floch-Prigent@)	Enron (Skilling@, Fastow@)~+ Tyco (Kozlowski@#, Swartz@) Ahold (Van der Hoeven#, Meurs#) Vivendi – Universal (Messier#@) Adecco (Weber#) Resona (Japan) SembCorp (Singapore) Lernout&Hauspie (Belgium) Global Crossing~ KPNQwest (Neth.)~ Healthsouth, Xerox, Reliant Energy, PWC, AOL Time Warners, Shell (Watts)# Computer Associates (Kumar, Richards)@ Fannie Mae (Raines#, Howard#)	Ahold (Van der Hoeven#, Moberg) KPN (Scheepbouwer) New York Stock Exchange (Grasso)# Skandia, ABB (Sweden) Adecco (Switzerland) Mannesmann (Germany)## Hollinger (Canada) (Black)# GlaxoSmithKline (Garnier)

Source: press clippings; * CEOs, CFOs or other directors; @ jail sentences, imprisoned; ~ bankruptcy or taken over; +suicide/deceized; ε executed; ## case acquitted; # resigned; ++ financial settlement of charges (without admitting guilt); ** 'Rogue trading'; *+ suspended

These affairs struck at the heart of the business system itself and involved some of its best-known business 'icons' (both persons and companies). The 2001 collapse of energy company Enron in the United States, following malpractices of its top management

[2] Even in the United States, the country with the highest trust in businesses as legitimate actors in society (see chapter 6), citizens have become increasingly critical. A Business Week/Harris poll released in September 2000 found that 82 percent of those surveyed agreed that 'business has too much power over too many aspects of our lives".

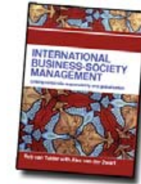


board, epitomized the largest bankruptcy in American corporate history. But it also brought the disputed mix-up of roles of auditing and consultancy firms to the fore (see also section 7.2) and seriously questioned the rationality of the merger wave of which Enron had been a leading proponent. The affair came as a surprise for professional industry observants and therefore also shook the trust in company rating agencies. Enron in particular had been portrayed as a 'best-practice' ethical company and was billed by Fortune as "America's Most Innovative Company" for six straight years from 1996 to 2001. Personal ties between Enron's CEO and president Bush Jr. threatened to affect the legitimacy of the political sphere as well. The insider trading case of American television personality Martha Stewart in 2003/2004 was headline news for months, not in the least because it involved the first female CEO of a company being sent to jail. In terms of self-enrichment this case was very small compared to other cases, but its 'icon' value the greater.[3]

The ripple effects in other countries were comparable. In the Netherlands, the European equivalent of the Enron scandal took place. It involved one of the world's largest retailers (Ahold) and in 2003 led to the resignation of its CEO, who had several times been proclaimed 'manager of the year'. In Korea, the Hyundai-Asan conglomerate (a leading *shaebol*) performed a key role in the very strategic relationships between North and South Korea. The suicide in 2003 of its CEO following charges of corruption and embezzlement signified much more than a personal tragedy. In France in 2003, the resigned CEOs of Vivendi Universal and France Telecom – both companies brought to the brink of bankruptcy following accountancy scandals - were prominent exponents of the Grandes Ēcoles (ENA) system that had been such an integral part of the French success story (see chapter 2). The members of the board of German engineering company Mannesmann in 2004 were charged with breaching their fiduciary duty to the company by approving bonus payments worth 60 million euro to themselves after UK company Vodafone bought the company in 2000. The members (acquitted in 2005 from further prosecution) represented key carriers of the German industrial system, such as the chairman of Deutsche Bank, the largest industrial bank, and the leader of IG-Metall, the biggest trade union. The case in 2004/2005 in Russia against the CEO of oil company Joekos - opponent to president Poetin and prominent member of the so called oligarchs – represented as much a political trial as one dealing with corporate corruption and fraud.

Are these 'scandals' incidents or do they reveal structural and strategic patterns? A number of the scandals resulted in sentences or resignations (or worse) by the people involved (See Table 1). So it could be argued that either the firms themselves showed sufficient auto-correction powers, or the judiciary system proved sufficiently apt in enforcing existing rules. But the scandals also appeared in waves, reveal a lack of clarity in institutional arrangements and inaptitude to deal with new business trends and strategies – all inviting managers to explore the boundaries of their fiduciary duties. Societal Interface Management strategies always develop in interaction with the regulatory environment.

[3] Martha Stewart was accused of self-enrichement of U$ 40.000, whereas in Enron, WorldCom and/or Tyco executives were charged with embezzlement and fraud of amounts between U$ 600 million and U$ 11 billion (WorldCom, the largest fraud case in history).



2. Incidents as an expression of company strategies

In most incidents it is difficult to distinguish between company and personal strategies. This applies particularly to the wave of mergers and acquisitions in the 1990s. Most Mergers and Acquisitions (M&As) were only possible by issuing extra shares, which provided a source of cheap capital, making the market capitalisation position of a firm very important for rapid growth. At the same time, executive payments of top managers had increasingly come in the form of stock options of the own company – legitimized by its supposed loyalty increasing effect on relatively mobile CEOs (see chapter 3). Influencing or manipulating the market capitalisation of their companies thus became double important for top managers. Many researchers have suggested that the prime rationale for the merger wave might not have come from the (supposed) performance enhancing effects of the new combination, but was primarily inspired by the promise of higher earnings for the top managers. This suggestion has in any case ex-post credibility, because salaries increased whilst the performance of the firm generally declined after the merger.[4] At the time the stock boom came to an end (bursting the dot.com bubble), it became additionally difficult for companies to sustain the higher stock prices needed to finance take-over ambitions and high executive payments and the M&A wave (temporarily) came to a halt. Some observants do not reproach managers for stretching their fiduciary duties; instead they reproach governments for not imposing effective competition policy (anti-trust) rules that would have contained the speculative sides of the M&A wave.

Consequently, many of the 'scandals' revealed a more or less systemic pattern: (1) they generally involve publicly listed companies, that (2) defined very ambitious profit targets, for which they (3) had to engage in very rapid growth strategies on the basis of (often cross border) acquisitions financed by issuing additional shares. Furthermore, the companies were (4) headed by strong – transformational - leaders that have a strong personal stake in the growth of the company, (5) had weak internal control on insider trading and fraud[5] and (6) had a relatively flexible and not very independent auditor that combined auditing and advisory. The take-over (7) created an occasion for high executive bonuses and/or lavish 'golden parachute' arrangements that would otherwise have been more difficult to legitimise.

Specific industries have been more struck by scandals than other industries. There seems to be a link between firms actively engaging in using tax harbours to manipulate international earnings and the occurrence of accountancy scandals. Next and related to the previous factor, top managers of service-oriented companies (finance, utilities) in

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[4] Numerous studies on the stock value and profitability of merged firms shows that these tend to be lower than before the merger. Consumers are also negative on the performance of merged firms. An American customer satisfaction Index report on customers' perceptions of the services of 28 big companies involved in a merger between 1997 and 2002, showed that even two years after the deal around 50% of the consumers say the are less satisfied (Business Week, December 13, 2004).

[5] Research in the Netherlands in 2003 by CenE Bankers, amongst publicly traded companies revealed that none of the Dutch companies – with the exception of financial services firms – had internal sanctions for insider trading of the own employees. One third of the 'compliance officers' did not have the authority to forbid trade in the companies shares by insiders (Volkskrant 6 november 2003)

particular have shown a vulnerability to breaching their fiduciary duty. In many of the scandals, international banks were also indirectly involved, for instance in re-arranging Parmalat's debt-problem; three large American banks were involved in Enron's fraud and settled off-court with amounts of around $ 100 million without admitting guilt.

3. Waves of scandals and regulatory voids

The waves of affairs were closely associated to the appearance of timely regulatory voids. The 'rogue trading' scandals (Barings, Sumitomo bank, National Australia) of the mid-1990s, involved primarily financial professionals who created fictitious options position in order to hide current loses and hedge real positions. But the scandals also represented a search of managers and companies how to deal with the relatively new business area of trading 'derivates' and 'futures'. This new market had been difficult to regulate and even to define. So all managers in a way were stretching their fiduciary duties to cover a new market. The scandals represented also a search for an interpretation of existing (wide and multi-interpretable) rules and are therefore difficult to proof in court (see box). The firms involved all stated that the managers operated without the consent of top management, but because of the systemic occasion of the issue, this continues to remain a point of debate.

Enron: one corner-cutting exercise too much…

"The Enron scandal did not burst out, fully grown, from the corporate landscape in a matter of days. Across corporate America widespread corner cutting, steadily falling standards, and copromised financial discipline had been festering for close to a decade. […] It was in that environment, and only that environment, that the Enron debacle could emerge. It was not simply the outgrowth of rampant lawbreaking. The true story was more complex, and certainly more disturbing. For crime at Enron – and, no doubt, there was crime – was just one ingredient in the toxic stew that poisoned the company. Shocking incompetence, unjustified arrogance, compromised ethics, and an utter contempt for the market's judgment allplayed decisive roles. *Ultimately, it was Enron's tragedy to be filled with people smart enough to know how to maneuver around the rules, but not wise enough to understand why the rules had been written in the first place."*

Kurt Eichenwald, 2005: 11, italics added

Insider trading scandals are another (alleged) breach of fiduciary duty that relate to (temporary) regulatory voids. Insider trading got its negative connotation in the 1980s in the wave of hostile take-overs that was carried by the introduction of a financial novelty: junk bonds. Two notorious corporate raiders Michael Milken and Ivan Boesky were initially heralded as modern-day heroes of capitalism, but ended up in jail, following Wall Street's biggest insider-trading scandal. Presently, considerable regulatory ambiguity still exists for the insider trading issue. Insider trading can include both legal

and illegal conduct. Corporate insiders trading in their own companies' securities are generally considered legal provided they report it to the security authorities. The fact that this form of insider trading proofs very profitable for the managers involved does not lead to adjusted regulation.[6] In the USA illegal insider trading relates to the buying and selling of a security – or tipping others - "in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security" (www.sec.gov). In other countries, comparable systems exist with often even weaker possibilities of addressing the issue in court. There remains room for overlap between legal and illegal insider trading. As a consequence, illegal insider trading is difficult to prove.

Following the 1990s wave of mergers and acquisitions (see section 3.4), the temptation to engage in dubious insider trading acts undoubtedly grew, but the actual practice of 'illegal' trading remained difficult to prove and/or regulate.[7] The number of cases brought to investigate indeed increased. NASDAQ for instance handles over four hundred insider trading investigations per year. Sanctions remain relatively modest. In developing countries, the number of proven insider trading cases is even smaller. Many of these countries still lack the means and legal framework to effectively address illegal insider trading. Even developed countries initiated some form of regulation only in the 1990s.[8]

Regulatory voids make that issues are strongly related. Accountancy rules' bending, fraud, corruption, insider trading, self-enrichment, golden parachutes and top executive compensations have often come together in a blurred web of otherwise creative accounting and mixed governance practices. The 'incidents' revealed fundamental weaknesses in the self-regulating powers of firms due to mixed responsibilities of executives and non-executives in Anglo-Saxon countries and the vague position of CEOs vis-a-vis the board of directors in other governance systems. The primary responsibility of auditors/accountants proved extremely unclear as well: were they auditing on behalf of society, shareholders or the board of directors? Governance rules in all countries - even after changed corporate governance regulation - leave considerable room for interpretation on the prime fiduciary duties of top managers.

The very definition of what constitutes a 'scandal', therefore proofs context dependent. Very high bonuses, golden parachutes and other indirect payments to executives have been considered particularly 'scandalous' in European and Asian countries. In Anglo-Saxon (liberal) countries high compensation and premiums are generally considered

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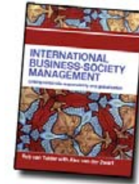
[6] A study in the United States, covering 66,465 US households from 1991 to 1996 showed that the average household's portfolio underperformed the market by 1.44 per cent a year, on average, while corporate insiders (defined as senior executives) usually outperform by about 5 per cent (Financial Times, February 24, 2004).

[7] For instance, US senators' personal stock portfolios outperformed the market by an average of 12 per cent a year in the five years to 1998, according to a study by Alan Ziobrowski of the Robinson College of Business at Georgia State University (Financial Times, February 24, 2004). But does that mean that they were able to make use of their 'insider knowledge' and access to non-public information, or that in order to become a US senator you have to have more than average intelligence as it comes to working the capital markets?

[8] When by the beginning of the 1990s, an EU Directive was passed on insider trading, four of the then twelve members of the EC – West Germany, Belgium, Italy and Ireland – had no insider trading legislation. Several of the members took time well beyond the 1992 deadline to get legislation in place. Luxembourg, for example, enacted its version of the Directive only in 1998.

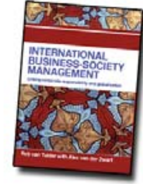


much less of a problem[9]. The average departing CEO in the United States received a severance package worth $ 16.5 million (The Economist, 12 October 2003: 74). High executive payments are deemed less problematic in these countries, except when it involves extreme compensation payments to 'public' or 'semi-public' officials as in the case of the New York Stock Exchange chairman, Richard Grasso, who earned a $ 140 million compensation. Income inequality between top executives and ordinary workers in Anglo-Saxon countries increased greatly. In 1970 the average real annual compensation for top 100 executives in the United States ($ 1.3 million) was 39 times the pay of the average worker, in 2005 it has become over 1,000 the pay of average workers (at $37.5 million) (The Economist, January 1st, 2005). As regards fraud and insider trading the pattern is reversed. Breaches of fiduciary duty towards shareholders have become considered particularly scandalous in the Anglo-Saxon countries and heavy penalties and sanctioning policies were enacted.

4. Evolutionary or revolutionary solutions?

The discussion on the real causes of the problem of fiduciary duty abuse is far from over. Since regulation can only solve part of the problem, and lacks behind the strategic realities of firms, the discussion has moved towards the governance foundations of publicly funded capitalism. Issues are: the separation of ownership and control, increase transparency, control and accountability. But the discussion also moves into a more fundamental direction: the limited personal liability of the owners (shareholders). What has been an important condition for growth in the early phases of capitalism (risk taking on the basis of limited liability), has turned into a formula for irresponsible behaviour by managers and low commitment by shareholders. An increasing number of observants (Micklethwait & Wooldridge, 2003; Mitchell, 2002; Kamp, 2003) have started to plea for the abolition of the limited liability of shareholders. They argue that abolishing the system of limited liability altogether would make business more accountable and responsible. This proposal would revolutionise the system of modern capitalism, though, and is not really seriously considered in any country. The Sarbanes-Oxley law in the United States that was enacted after Enron and comparable cases, imposes greater personal liability upon top managers of companies, but not on shareholders. No other country has yet followed the American example.

[9] The most important criticism to chief executive remunerations is not related to the levels, but to (1) the way companies camouflage their top executives' pay, (2) that the pay is often unrelated to performance and (3) the remuneration package of CEOs is decided by outside directors that might not have the best interests of shareholders in mind (Cf. Bebchuk, Fried, 2004).



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