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Strengthening the Ties that Bind: Preventing Corruption in the Executive Suite[+]

by

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Abstract

High-profile corporate scandals earlier in this decade provoked outrage and legislative action, however corporate executive-level ethical lapses continue to come to light. This article examines the work of Professor Dunfee and his co-authors on corruption, ethical leadership, and social contracts theory, and relates that literature to corrupt activities by corporate executives. Corruption is defined broadly to encompass executive self-dealing, which harms their firms. The specific example of stock options backdating is used to show the harmful impact on shareholders and the lack of managerial integrity though consequentialist, deontological, and legal analysis, as well as a critique of the practice using social contracts principles. Ultimately, the article utilizes the insights of Dunfee and his co-authors, and the lessons from the backdating example, to propose a framework aimed at improving corporate governance and preventing future executive corruption. The framework includes a strategy of identification and prevention, employing detection and eradication mechanisms, and institutional learning from past instances of corporate corruption.

Keywords: corruption, corporate governance, stock options backdating, executive and management ethics, private corruption, fiduciary duty

JEL Areas: G3, G34, G38, K2, K22, K4, K42, M1, M14, M52

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In the early 2000s, the list of major U.S. firms engaged in large-scale corporate fraud included Enron, WorldCom, Tyco, and Adelphia, to name just a few of the most cited examples (Mahat, 2008, p. 913). These prominent scandals ranged from complex accounting frauds involving special purpose entities and off-balance sheet transactions (Schwarcz, 2004, pp. 1-7) to more obvious thefts of corporate assets (Green, 2004, pp. 38-41). In particular, the frauds at Enron and WorldCom provoked public outrage and congressional reaction (Grundfest, 2002, pp. 1-2), resulting in promulgation of the Sarbanes-Oxley legislation (2002) (White House, 2002), which attempts to require further oversight over the activities in both the corporate boardroom and executive suite in an effort to combat corporate corruption.

Despite this expansive federal legislation, the executive suite has not rid itself of internal corruption. The once much applauded practice of granting executive stock options (Jensen and Murphy, 1990, pp. 139-140) as part of high-level employment compensation has recently been discovered to have resulted in corporate fraud and corruption, in the form of the options backdating scandals. Although revised accounting practices will likely prevent the sort of backdating engaged in until recently, new corporate scandals have already begun to emerge, demonstrating the need for forward-looking ethical reforms rather than reactionary regulations. This wave of new corporate ethics lapses helps demonstrate that the framework proposed in this article is one way to insulate against further scandals.

Professor Thomas Dunfee, together with several co-authors, has written extensively in the business ethics literature on the problem of corruption, and provides us with a starting point for reforming boardroom ethics. Dunfee's focus has been for the most part on the major, multinational issue of traditional corruption or "coarse" corruption (i.e., bribery). For example,

as Professors Dunfee and David Hess highlight, "the level of corruption that exists is staggering in scope" and "also imposes tremendous costs on business" (Hess and Dunfee, 2000, pp. 596-597) and governments, and even impacts human rights (Hess and Dunfee, 2003).

Moreover, Dunfee's writing on related issues of business ethics in the corporate world has implications for efforts to curb corporate corruption, particularly on the supply side (from bribe payers). For instance, with Professor Mark Schwartz and Michael Kline, Dunfee (2005) has argued that it is essential that a firm's leadership establish the proper ethical "Tone at the Top," in part because legal prohibitions alone cannot prevent corporate scandals such as WorldCom, Tyco, and Enron. Professors Donaldson and Dunfee's extensive work on Integrative Social Contracts Theory (ISCT) in their landmark book *Ties that Bind: A Social Contracts Approach to Business Ethics* (1999) is also crucial to understanding why the options backdating scandals violate business ethics norms. This is because the connections – essentially the rights and obligations – among a firm's managers and stakeholders, including shareholders, are explained by the social contracts and norms Donaldson and Dunfee identify.

Although Dunfee's corruption-specific work primarily considers the issue of corruption from the viewpoint of the multinational firm's interaction with governmental officials, such as the payment of bribes, these theories can be applied to the issue of corporate fraud originating within the firm. For our purposes, we define corruption broadly to include self-dealing of corporate executives, to the detriment of their firms. In doing so, we acknowledge emerging trends in the academic literature that address private-to-private corruption (Argandona, 2003) and define corruption expansively (Kurer, 2005). In this sense, we are categorizing the harmful rent seeking behavior represented by the executive options backdating scandals as an example of corporate corruption.

Anti-corruption advocates are also increasingly subscribing to a wider view of the definition of corruption. For instance, Transparency International, the leading anti-corruption nongovernmental organization, "has chosen a clear and focused definition" of corruption as "the misuse of entrusted power for private gain" (Transparency International, 2008a). This definition is open to the inclusion of a variety of acts beyond basic or coarse bribery. In its efforts to move beyond simply addressing bribery, Transparency International is expanding its work to include discussion of intra-firm corruption, such as fraud and conflicts of interest, in its upcoming *Global Corruption Report 2009* specifically addressing private sector corruption (Transparency International, 2008b).[1]

Building off the work of Dunfee and others concerning corruption, we focus on corrupt acts committed by executives in U.S. corporations over the last few years as a means of advocating a more comprehensive understanding of how corruption impacts business. These corrupt actions may involve outright fraud or theft, such as we have seen in the Enron, WorldCom, Adelphia, and Tyco situations, the options backdating scandals, or more subtle violations of the fiduciary duty of loyalty that executives owe to the corporation. A corporate culture that facilitates an executive's unethical impulse to put personal interests ahead of the interests of the firm may be as corrupt as one that promotes the payment of bribes to governmental officials. In both instances, the offending parties are acting without integrity and attempting to secure private gain at the expense of the trust placed in them by their constituents.

We examine recent stock options backdating scandals and find that Professor Dunfee's work on corporate corruption can provide guidance to corporate executives in combating internal fraud and self-dealing in the executive suite. To this end, this paper is organized as follows. Part I begins with a description of the options backdating scandal followed by an overview, in Part II,

of Professor Dunfee's and his co-authors' theories on combating corporate corruption, leadership from the top of the corporate ladder, and the social contracts that form the core of a management and board relationship to shareholders. In Part III we apply these corruption theories to the backdating scandals and propose a new framework for thinking about fraud and self-dealing in the executive suite. Part IV concludes. Our intent is, thus, to describe some of the ties that bind corporate constituencies together, discuss how those connections are strained or broken with corruption through scandals such as the backdating incidents, and, in the end, suggest ways to strengthen those ties for the future to avoid similar corporate corruption from taking root in the executive suite.

I. The Options Backdating Scandals

Stock options have been a popular component of executive compensation in the United States and have proliferated compensation plans in the last few decades (Hannes, 2007, pp. 1425-1428). Stock option packages have long been touted as a way to align the interests of the executive with the shareholders, thereby providing greater incentives for executives to improve firm performance.[2] There are many variations of stock option plans, but the most common are "at-the-money" options. At-the-money options are priced as of a specific date at the value the stock is trading at on that day. Normally, there is a vesting period before the executive can exercise the option by purchasing the stock at the previously granted price. The theory is that this type of compensation provides incentives for the executive to improve firm performance, increasing the value of the stock, and benefiting shareholders.[3] If the stock price rises after the option was granted, the option becomes profitable to the executive. The executive then may purchase the stock at the discounted prices and either sell the shares at a profit or keep them as a speculative investment.

An alternative to at-the-money options are "in-the-money" stock option plans. Here, the exercise price of the shares is priced below the current trading price. The executive must usually wait for a vesting time period to pass before exercising the option. In-the-money options are taxed as part of the executive's compensation, because he or she is receiving a discount on the stock price, and may profit immediately through the purchase and sale of the shares (Narayanan, et al., 2007, 1619-1621). Furthermore, prior to 2003, only in-the-money option grants were required to be expensed by the corporation when the grants were made (Narayanan, et al., 2007, 1622-1623). Before 2003, at-the-money grants were not so expensed (Narayanan, et al., 2007, 1623).

The options dating scandals involve a practice whereby some executives have changed the date of their options, and thus changed the price at which the options could be exercised, without disclosing that the options dates have been changed in documents filed with the Securities Exchange Commission (SEC) or the Internal Revenue Service (IRS). Executives engaging in what has become known as backdating have seen the share price of their firms on the rise. In this case, rather than report the actual date of the options grant, which would provide options that are at-the-money, the backdating executive reports a date in the past as the grant date, when the trading price was lower.[4] Thus, the options are converted to in-the-money options, but without appropriate disclosure.

Forward dating is the practice in reverse, where the options grants are not filed immediately with the Securities Exchange Commission, and the executive is expecting the firm's share prices to fall and then recover by the vesting date. When the executive decides to file the required documentation with the SEC, the executive reports a date later than the date the options were actually granted as the grant date, taking advantage of the decrease in the value of the

company's shares. Both variations of the dating games achieve the same result – which is a greater pay-out price when the executive chooses to exercise the stock option.

The *Wall Street Journal* has tracked the number of firms involved in the backdating scandal (Wall Street Journal Online, 2007). It is striking that the backdating practice appears to have been widespread. According to the *Wall Street Journal*'s estimate there have been at least 147 companies implicated in investigations over clandestine backdating practices (Wall Street Journal Online, 2007). In this regard, the practice, while it was ongoing, seems to have been rather analogous to various forms of corporate corruption, such as bribery of foreign officials by corporations.[5] Though widely condemned, international bribery is widely practiced (Hess and Dunfee, 2000, p. 595) and remains a concern for multinational corporations (Control Risks Group, Ltd. and Simmons & Simmons, 2006). The next Part considers the issue of corporate corruption, focusing on the analysis of Professors Thomas Dunfee and David Hess.

II. Corporate Corruption and Bribery: Dunfee and his Co-authors

As a means of understanding Professor Dunfee and his co-authors' theories on addressing corporate corruption, leadership from the top of the corporate structure, and the social contracts that connect various business-related constituencies, it is important to first consider a conceptual grounding for the theories. This section initially examines Dunfee's writings on fighting corruption and then endeavors to apply them to the specific business dilemma of the options backdating scandals.

A. Dunfee's Contributions to the Anti-Corruption Literature and Related Issues

In the late 1990s Professor Dunfee was at the forefront of voices recognizing that there was an emerging worldview on corruption (Hess and Dunfee, 2000, p. 600) involving, as then

World Bank President James Wolfensohn said, "publicly expressed revulsion, on moral, social, and economic grounds" (Coyle, 1997, p. 14). This trend is further represented by successful multinational efforts to generate awareness of the need to curb corruption, such as the Organization for Economic Co-operation and Development (OECD) Convention on Combating Bribery (1997) and the United Nations Convention against Corruption (2005).

Corruption, by its nature, is secretive and, the costs of corruption are often hidden from plain view and difficult to measure.[6] The most significant cost associated with international bribery may be the impact on the government (Hess and Dunfee, 2000, p. 596), however there is also an immense impact on corporations, particularly multinationals operating in developing countries (Control Risks Group, Ltd. and Simmons & Simmons, 2006, p. 3). As Dunfee and Hess write, "corruption limits a government's ability to perform vital functions and may even threaten its overall effectiveness" (Hess and Dunfee, 2000, p. 596). A clear cost of corruption is that bribery decreases the ability for a country to collect revenue because public officials take bribes in exchange for not imposing taxes or fines. A less apparent effect is that the corruption "also influences government spending, moving it out of vital functions, such as education and public health, and into projects where public officials can more easily exact bribes" (Hess and Dunfee, 2000, p. 597; citing Tanzi (1998) and Mauro (1998)).

Professors Dunfee and Hess posit four explanations for why corruption is widespread. These are: (1) competitive necessity, (2) wide-spread extortion, (3) independent actions of employees acting against corporate policies, and finally, (4) the view that bribes are ethically justified because they "respect local culture and avoid moral imperialism."[7] While acknowledging that all factors, including the last one, contribute to the prevalence of coarse public corruption, Hess and Dunfee critically examine the ethical justifications for bribery. In

turn, they eliminate these justifications and, ultimately, present what they call the Combating Corruption (C^2) Principles as a means of providing some guidance for corporations faced with the corruption dilemma.

As part of their approach, Hess and Dunfee begin by looking at the ethics of bribery through a consequentialist lens (Hess and Dunfee, 2000, p. 612). In this context, if the overall good created by coarse bribery outweighs the negative impact, there could be an ethical justification for bribery. They conclude generally that the total costs of bribery are widely viewed to outweigh the positive effects (Hess and Dunfee, 2000). When narrowing in on specific cases, the authors find that consequentialist analysis is ultimately insufficient to justify bribery because it is impossible to calculate the full social costs associated with one instance of bribery (Hess and Dunfee, 2000, p. 613).

Next, Hess and Dunfee employ a deontological analysis to examine the moral duties of parties involved in bribery (Hess and Dunfee, 2000, p. 613). They discuss whether there could be a superseding moral duty to respect the norms of other cultures. They conclude, however, that coarse bribery cannot be a cultural norm because it is universally illegal, violates the legally based duties of agency, and occurs only in secret (Hess and Dunfee, 2000, p. 613).

Finally, Hess and Dunfee also examine bribery from a social contract analysis. They explain, "The basis of the social contract approach is to identify the authentic norms of relevant communities that would apply to a given business decision" and "If these norms do not violate manifest universal ethical principles, they constitute a source of moral obligation." Professors Donaldson and Dunfee have developed this argument further concluding that coarse public sector bribery violates manifest universal ethical principles (Hess and Dunfee, 2000).

After determining that bribery cannot be ethically justified, Hess and Dunfee suggest possible solutions to reduce the prevalence of bribery. They address the need for an aggressive anti-bribery legal regime, but point to several obstacles to rigid universal enforcement (Hess and Dunfee, 2003, p. 263). First, there is doubt as to whether developing nations will be "willing and able to expend" the vast amount of resources required for enforcement (Hess and Dunfee, 2003, p. 263). Furthermore, corrupt practices may "adapt around the laws and continue to thrive." Dunfee and Hess conclude that "a criminal law approach by itself is not likely to work" and that governments must address corruption from many different angles (Hess and Dunfee, 2003, p. 263).

One such angle proposed by Hess and Dunfee are voluntary codes of principled conduct similar to the Sullivan Principles (Hess and Dunfee, 2000, p. 615).[8] Their Combating Corruption (C^2) Principles consist of twelve principles that were approved at the Caux Roundtable (Hess and Dunfee, 2000, p. 621). The goal of such voluntary codes is to diminish the supply side of corruption (i.e., bribe paying) (Hess and Dunfee, 2000, p. 626). Hess and Dunfee acknowledge the limitations of the C^2 principles while defending these types of framework and voluntary codes as an "important first step" (Hess and Dunfee, 2003, p. 271). These principles are intended to outline what corporations must do, at a minimum, to identify and eradicate corruption facilitated by members of their organization, as well as to guard against attacks by corrupt forces outside of the company.

Another of Dunfee's contributions to understanding the problem of corruption and potential approaches to fighting the issue is found in his ISCT work with co-author Professor Thomas Donaldson. In *Ties that Bind* (1999), Donaldson and Dunfee develop an adaptable theory of social contracts as a means of explaining cultural variations with regard to business

ethics practices. They posit that there are numerous microsocial norms that vary by community, but that are ultimately bounded by "hypernorms" that are universally accepted precepts (Donaldson and Dunfee, 1999, pp. 43-44). Hypernorms are at "the root of what is ethical for humanity" and "should be discernable in a convergence of religious, political, and philosophical thought" (Donaldson and Dunfee, 1999, pp. 44).

Ties that Bind also explains the ISCT model as applied to international business through discussing specific instances of corruption, namely bribery and sensitive payments (Donaldson and Dunfee, 1999, pp. 222-230). Within this example, the authors reason that bribery or sensitive payments are rejected across cultures because: (1) bribery violates the microsocial contract of the participants because it is in opposition to the duties of the agent (to either the government and the public, or a private entity), (2) bribery is not typically an authentic norm because all countries outlaw the practice and it is not accepted by the majority of the members of a community, and (3) bribery may violate the political participation and efficiency hypernorms (Donaldson and Dunfee, 1999, pp. 224-230).

In addition, Dunfee, along with co-authors Mark Schwartz and Michael Kline, has argued that, in part, ethical failures were key to most of the high-profile corporate scandals of the early 2000s, such as Enron, WorldCom, Tyco, and Adelphia (Schwartz, et al., 2005, pp. 85-86). They find that directors are a crucial source of ethical gatekeeping and:

> directors need to emphasize their ethical obligations because: (1) recent corporate scandals involved serious ethical failures at the board level; (2) the nature of boards requires observance of ethical obligations; (3) boards, charged with the ultimate responsibility of ensuring the ethics of their organizations, are thereby obligated to act as ethical role models; and (4) it is simply good for corporate business success for directors to be ethical (Schwartz, et al., 2005, pp. 88-89).

In supporting their arguments for an ethical "tone at the top" from a board of directors, Dunfee and his co-authors present "six core ethical values" that "become the organizing framework for any legal or ethical obligations for directors" and that should "underpin" a directors' code of ethics (Schwartz, et al., 2005, p 91). These principles are honesty, integrity, loyalty, responsibility, fairness, and citizenship (Schwartz, et al., 2005, pp. 91-94). Upon applying these principles to the role of the board, the authors conclude that the board's role must be an active one and, if properly fulfilled, can help guard against the ethical lapses that enabled some of the most notorious corporate scandals in history.

B. Implications for Private Corruption: The Options Backdating Example

This Part considers the question of whether the options backdating scandal, in light of the foregoing discussion, is an example of corruption and thus a violation of ethical and legal norms. We conclude that the practice fits widening views of corruption, in part because of its harmful impact on stakeholders and the lack of managerial integrity inherent in backdating. In addition, backdating activity can be analyzed as a deviation from both the ISCT principles and the values directors should hold and implement to set the crucial ethical tone from the boardroom.

1. Harmful Impact on Shareholders and Lack of Managerial Integrity

At a basic level, options backdating and other dating games are, by their nature, deceptive and aimed at enriching the party holding the option who is in a position of power to manipulate the dates on which the option is granted. If the granting of stock options to corporate executives is intended to align the interests of the corporation (and, thus, its shareholders) with the personal financial interests of the executives, changing the date of the options eliminates those incentives because the executives extract a personal gain without improving firm performance (Chhabra, 2008). Individuals who convert in-the-money options to at-the-money options, without

appropriate disclosure, are abusing their positions of trust and power to facilitate their private gain. If nothing else, it seems that undisclosed options backdating practices harm shareholders by removing compensation incentives for the executives to improve performance and raise questions of managerial integrity.

Further, comparisons to the coarse corruption situation demonstrate that backdating can be thought of as a form of corruption. Executives engaging in or enabling options backdating are shirking their responsibilities and thus violating the trust of their constituents for personal pecuniary gain. The options backdating scandals, like traditional corruption, fail consequentialist, deontological, and, increasingly, legal analysis and scrutiny, as discussed below.

a. Consequentialist analysis

To begin, the consequentialist lens that might yield a defensible result with coarse bribery situations where some just end justifies the otherwise corrupt means, does not justify backdating practices. This is because the improper impetus for backdating games is simply to enrich the executives who hold stock options. The corporation does not benefit from the practice and there is empirical evidence suggesting that the practice harms the firm. Professors Narayanan, Schipani, and Seyhun found that, on average, the market capitalization of firms in their sample dropped by $389 million upon investigation of options backdating practices (Narayanan, et al., 2007, p. 1638). The average gain to executives, in this sample, was approximately $.5 million, per firm. They conclude that “stockholders are paying a substantial price for managerial indiscretions of rather small benefit to the executives of these firms” (Narayanan, et al., 2007, p. 1638).

Perhaps even worse, backdating practices may harm shareholders derivatively due to fines and penalties the corporation incurs from violating securities and tax laws. In addition,

attempts to hide compensation offend the best practices principles of corporate governance, namely transparency and accountability (Organization for Economic Co-operation and Development). Furthermore, backdating benefits only the options holder at the expense of the integrity of public markets and a company's financial accounting practices.

As a counterargument, imagine that, perhaps, the proliferation of options backdating across a wide range of U.S. firms evidences acceptance of the practice (Wall Street Journal Online, 2007). In other words, there might be an argument that the culture of U.S. boards of directors and executives focused on increasing executive compensation among those individuals seems to have adopted the practice wholeheartedly, perhaps evidencing support of the results of options backdating. To the contrary, however, it is apparent from the public outcry and the subsequent investigations and prosecutions, that the broader U.S. business culture and the public have similar disdain and revulsion for backdating as they have with coarse corruption.[9] In other words, the outcome of options backdating activity does not benefit other stakeholders. Rather, backdating harms their interests and the practice is indefensible on the grounds that it produces some common good for stakeholders.

b. Deontological analysis

Similarly, as Dunfee and Hess demonstrated with bribery, options backdating also fails a deontological analysis. When analyzed from a strict duty perspective, secretive options backdating cannot be ethically justified. Assuming that shareholders permit in-the-money options, compensation committees could grant executives backdated options and report them as such on the financial statements. The scandal arises when the executives change the date on the options grant, without disclosure, and thus violate their ethical and legal duties to shareholders.

That backdated grants were kept secret implies that they were understood by the executives as being unacceptable to shareholders or other market participants. Even if not illegal, would a virtuous executive engage in secret backdating? Or, stated another way, would the public (or the company's shareholders, a subset of the public), agree that executives should have the ability to manipulate the system to increase their compensation when rank and file employees are unable to exercise that same power? The answer to both questions is almost certainly, no.

To put it simply, there is an obligation to tell the truth to shareholders and other stakeholders and, thus, backdating stock options is a form of lying. That backdating is practiced in secrecy makes clear that it is an intentionally opaque activity. Moreover, the unfair treatment of those in the executive suite over rank and file employees also fails to comport with notions of justice and equality.

c. Legal analysis and scrutiny

There are a number of legal issues presented by the backdating scandals. First, the financial statements filed with the Securities Exchange Commission do not accurately report expenses (Narayanan, et al., 2007, pp. 1622-1623). The backdating practices have converted at-the-money options into in-the-money options, which were required to be expensed (Narayanan, et al., 2007, pp. 1622-1623). Furthermore, the inaccurate financial statements may be fraudulent or at least misleading in violation of the federal securities laws (Narayanan, et al., 2007, pp. 1607-1615, Jayaratnam, 2007). For example, two Brocade Communications Systems, Inc. executives were found guilty of criminal fraud related to the backdating scandal.[10] Several other executives have been charged with criminal and civil fraud violations (Wall Street Journal Online, 2007).

Second, at-the-money options were not taxable to the corporation whereas in-the-money options were – reflecting both improper tax payments as well as inaccurate financial reporting (Narayanan, et al., 2007, pp. 1619-1622, Walker, 2007, p. 575). Both companies and executives have been required to pay back-taxes and penalties (Narayanan, et al., 2007, pp. 1622-1623). Backdated options do not qualify as incentive pay because they are in-the-money. Therefore, the option is counted against the $1 million per year deduction cap created by Internal Revenue Code section 162(m) (Narayanan, et al., 2007, pp. 1622-1623; Internal Revenue Code, 2000).

In addition, courts are finding that shareholder claims for breach of fiduciary duty, under state corporate law, are valid claims surviving motions to dismiss. State corporate laws, in general, require directors and officers to act with due care with respect to corporate affairs[11] and to put corporate interests ahead of personal interests.[12] This latter duty, known as the fiduciary duty of loyalty, also requires these executives to act with good faith.[13]

In *Ryan v. Gifford* (2007), the Delaware Court of Chancery denied a motion to dismiss a derivative law suit against Maxim Integrated Products for its options practices. The court was "convinced that the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the director's purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith" (*Ryan v. Gifford*, 2007, p. 358). Furthermore, the court was "unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosure, obviously intended to mislead shareholders into thinking that that the directors complied honestly with the shareholder-approved option plan, is anything but a an act of bad faith" (*Ryan v. Gifford*, 2007, p. 358).

Similarly in *In re Tyson Foods, Inc*., (2007, p. 591) a derivative suit against directors alleging stock options manipulation survived a motion to dismiss. The court found that the alleged practice of "spring loading" would violate the directors' obligation to act in good faith requirement of directors (*In re Tyson Foods*, 2007, p. 593). Spring loading involves the practice of granting stock options at a time when the board knows that their value would soon increase. According to the court, "A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary" (*In re Tyson Foods*, 2007, p. 593).

Finally, it is also noteworthy that although stockholders were led to believe that stock options compensation schemes helped align the interests of management and the stockholders by providing incentives for the executives to improve performance, those incentives are no longer in play when options are backdated. That is, executives were able to reap financial rewards without improving performance. Moreover, by changing the options granting dates, the executives rewarded themselves with clandestine compensation.

2. Deviation from Social Contract Principles

Backdating, like bribery, is also potentially wrong because it violates the macrosocial contracts between those in positions of trust and responsibility, and their constituents. Arguing that illicit options backdating is analogous to coarse corruption is potentially provocative. However, there are several important parallels in how the activities are conducted and in the impact of both practices. That is, when a corrupt official's bribe taking allocates public resources outside of political control of the citizenry it skews the efficient distribution of

resources (Fort, 2001, 140-141). In the context of a public company, where the shareholders are the constituents, executives who engage in options backdating are, like bribed public officials, violating their duties and making decisions based on their self interest, and not engaging in the transparent and efficient behavior that benefits the company's owners. They are increasing their compensation, like officials who take bribes, outside the view of their constituents, who, in the case of backdating, are the shareholders.

As an illustration, assume that the pervasiveness of options backdating across a wide range of U.S. industries (Wall Street Journal Online, 2007) evidences acceptance of the practice in some circles and organizations. Would the widespread acceptance of backdating among those in the executive suite undermine the assertion that the practice is unethical? This would be analogous to an organization that develops a normative psychological contract in favor of discriminatory hiring (Donaldson and Dunfee, 1999, p. 149).

To the contrary, in that circumstance such an organizational norm would be considered inauthentic because it is directly inconsistent with larger, community-level social contracts (Donaldson and Dunfee, 1999, p. 148). Backdating only benefits the options holder and does so at the expense of the integrity of public markets and a company's financial accounting practices, Moreover, like bribery and suspect payments, backdating violates established social contracts and legal duties between owners and managers, under which managers are obligated to remain loyal to their shareholders.

Evidence of this violation of a macrosocial contract is found in the disdain for options backdating articulated in a variety of sources. It is apparent from the public outcry and the subsequent investigations and prosecutions, that the broader U.S. business culture and the public have similar disdain and revulsion for backdating as they have with coarse corruption. A low

view of executives who engaged in options backdating is apparent in the financial press reports on the backdating cases within the last few years.[14] For example, the *Wall Street Journal* is credited with breaking the story of widespread, suspect instances of well-timed exercising of stock options (Forelle and Bandler, 2006). Thereafter, the financial press often described the practice as a "scandal" (Henry 2006) (i.e., "the wide-ranging practices [of backdating] became corporate America's biggest scandal last year" (New York Times, 2007)). Early on after the news of the potential backdating liability for hundreds of U.S. companies broke in 2006, former SEC chairman Harvey Pitt recounted in *Forbes.com* that "there's a new kind of fiduciary misconduct floating around: options backdating" (Pitt, 2006). The British newspaper, *The Independent*, commented that backdating was "the scandal Wall Street can no longer dismiss as 'a few bad apples.' In what amounts to systematic corruption, dozens of American companies stand accused of manipulating share options to inflate executive pay artificially, then lying to shareholders about it" (Foley, 2006).

Furthermore, in response to a *BusinessWeek* article suggesting that the fears of a huge swath of backdating prosecutions might be overblown (Burrows and Woellert, 2007), another *BusinessWeek* staff writer and commentator wrote: "A lot of [Silicon] Valley execs knew backdating was wrong, because it's misleading no matter how much you try to explain it away by saying 'everyone was doing it'." Moreover, "Fact is, many companies purposely didn't do it because it smelled bad. And the notion that nobody benefited and shareholders didn't get hurt is absurd" (Hof, 2007).

That options backdating, even in a generalized sense, is perceived as a scandal in the press and as corruption from perspective of the government prosecutors, demonstrates the negative social perceptions of the practice. Additionally, backdating looks strikingly similar to

bribery when considering Professor Timothy Fort's analysis of how Donaldson and Dunfee's ISCT work applies to bribery. First, backdating, like bribery, can be seen as a violation of "a role duty in a principal-agent relationship" (Fort, 2001, p. 140). In this regard, options backdating is a similar violation of an executive's duties of loyalty and care to shareholders. Second, backdating, like bribery, is not viewed as moral, even in the communities where it was practiced. Third, options backdating practices, again, like bribery, violate cultural norms by its illegality.

Accordingly, backdating executives reap a private gain by abusing the trust and assumptions of loyalty that comes with their position, akin to public corruption. The next section builds on the previous arguments to suggest a forward-looking framework for anticipating and addressing business ethics dilemmas such as the backdating scandals.

III. A Framework to Prevent Corruption in the Executive Suite

This section argues that, with the insight of Dunfee's anti-corruption, ethical leadership, and social contracts work – as well as the lessons from the options backdating scandals – there is a cohesive, forward-looking approach that can shed light on how to curb ethical failings in the executive suite. This proposal targets fraud, disloyalty, and self-dealing among corporate executives, which are the same underlying corrupt acts that gave rise to the backdating scandals. More importantly, this framework can serve as a normative model for how the next and as yet unforeseen corporate scandals might be addressed or avoided. Effective detection, investigation, enforcement, and education from regulators at the Securities and Exchange Commission is a key external approach to dampening corporate malfeasance by executives. Our proposal focuses on

what can be done internally, at the corporate level, to address ethical challenges in the executive suite.

We first suggest that a portfolio approach, similar to that advocated by Dunfee and Hess when addressing bribery through the C2 Principles, is optimal to help establish a cycle of: (1) identifying and preventing potential ethical lapses, (2) establishing mechanisms at the firm level to detect and eradicate corruption, and (3) learning from past failures to provide positive feedback to engage in self-regulation and return to the beginning of the cycle. These elements of curbing corruption in the executive suite are addressed in turn, below.

A. Identifying and Preventing Potential Ethical Lapses

The logical first step to curbing corruption in the executive suite is to begin by identifying potential areas of exploitation for unscrupulous corporate leaders and then using that insight as a means of proactively preventing opportunities for ethical abuses. Part of an effective strategy for addressing corruption includes an understanding of individuals' motivations and behaviors, including those of wrongdoers (Shkolnikov and Wilson, 2005). The most obvious motivation for unethical decision making in the executive suite is, simply, greed. If, as some legal commentators have concluded, the options backdating cases could not have arisen without some level of intent in manipulating corporate processes (Lebovitch and Gundersheim, 2008, p. 519) ethical failings in the future could be curbed if effective safeguards are in place.

Now that secret backdating practices have come to light and are almost universally abhorred, stakeholders, government regulators, and auditors are, in general, alerted to that specific sort of corrupt activity and presumably it is no longer occurring on a large scale. Lessons learned from the backdating scandal, however, provide valuable insights for improved governance practices that may help prevent other similar scandals in the future. For example, it

may be useful for firms to envision the board, and particularly the board's ethics committee, as an active gatekeeper, rather than as a passive panel which only addresses issues brought to its attention. Classical financial market gatekeeping theory envisions gatekeepers as third parties who are capable of disrupting wrongdoing by withholding their assistance (Kim, 2008, p. 415). Examples of traditional gatekeepers include lawyers and accountants who are needed to certify accounts and who would not permit falsification by a corrupt executive.

The internal committee structure already in place at public companies, however, might serve an ethical gatekeeping role. For instance, a corporation's ethics committee could be tasked with a new level of proactive oversight by initiating inquiries into the executive compensation structure as a check on the activities of the firm's compensation committee. In this way the ethics committee could also employ outside expertise to remain informed of potential ways in which executive corruption is arising at other firms. If corporate boards employed this sort of market-wide self-awareness in the 1990s, the wave of backdating scandals may have been better foreseen and, at the individual firm level, corruption may have been addressed sooner.

Moreover, a more engaged ethics committee could strive to be aware of other simmering potential abuses related to executive compensation, conflicts of interest, and even simply addressing shareholder and public attitudes about executive perks, such as private jets and massive severance packages. The goal is to have an ethics committee that is designed to anticipate ethical pitfalls and loopholes that are ripe for exploitation by corrupt executives, much like the deceptive backdating activity.

B. Establish Mechanisms to Detect and Eradicate Corruption

The next element of a broad, portfolio approach to curbing corporate corruption is establishing mechanisms at the firm level to detect corruption. Once an ethics committee is

tasked with identifying ethical trouble spots with regard to executive compensation, the next step would be to set up governance structures and policies that encourage detection and eradication of internal corruption among executives. In a general sense, this is an approach that recognizes the value of transparency in the realm of executive compensation, even when a heightened level of openness and disclosure is not yet required by law or common practice.

To detect and work against a culture of executive corruption and violation of fiduciary duties, a firm's governance structure can tap into the monitoring abilities of both its employees and outside experts. In the case of a company's employees, the firm – perhaps at the impetus of the shareholders – might adopt and promote internal whistleblower protections. The potential result may be a culture shift within firms toward greater internal reporting of executive abuses.

An extension of transparency for the sake of detecting abuses originating at the executive level could involve employing outside experts to act as executive suite auditors for the purpose of identifying ethical risk in various corporate policies. This oversight would include a review of executive compensation policy and identifying policies that may give rise to potential conflicts of interest. An outside perspective may be a useful mechanism for increasing transparency and credibility of executive suite reporting. In addition, this may also be a helpful way to outsource the development of compensation audits by delegating a broad mandate to the auditors to gather information and initiate disclosure of all executive activities that could qualify as stealth compensation, such as elaborate perks or post-employment benefits. To the extent that the information is not legitimately confidential or proprietary, it should be available to shareholders.

C. Learn From Past Failures

Third, and perhaps most importantly, is for a company to learn from past failures, both internal and those at other firms, to provide positive feedback for engagement in self-regulation.

Here, Dunfee and his co-author's research about setting the proper "tone at the top" becomes relevant. Executives and directors need to lead by example and, as Dunfee's writing suggests, set the tone at the top as a way of orienting an organization. In particular, directors should have an increased role as ethical gatekeepers of the practices of corporate executives and, by extension, the corporation's activities.

A tone at the top emphasis by a board of directors is grounded in the six "core ethical values" that form the nucleus of a board code of ethics: honesty, integrity, loyalty, responsibility, fairness, and citizenship (Schwartz, et al., 2005, pp. 91-94). In some of the backdating scandals, directors may have explicitly allowed executives to change the grant dates and, thus, violated these principles. Yet, the chance that backdating would have been detected and labeled as unethical by boards would most certainly have increased if the boards and executives of backdating companies had adhered to these principles. More abstractly, if, as Dunfee and his co-authors suggest, these principles can permeate an organization from the top down, the ethical leadership of the board may also influence the entire culture of a firm and help insulate the corporation from instances of corporate corruption.

The forward-looking use of these six principles comes in to play in several ways. First, the principles, even to the extent that they mirror existing law on the corporate duties of loyalty and care, can be integrated into a firm's governance documents, as well as codes of conduct. Second, the importance of the six principles and their application to detecting, and then preventing, corruption can be affirmed by shareholders via shareholder resolutions addressing expectations of executive and board member behavior.

Similarly, shareholders can insist that any material deviation from these principles have consequences for corrupt executives. This can be accomplished by integrating language that

makes a violation of these principles as sufficient grounds for a "for cause" termination of executive employment and compensation contracts, making the ethical duties to the corporation a supplement to existing laws on agency principles of duty of care and loyalty. In the extreme, adding these principles to the contractual basis of executive compensation would provide shareholders with additional leverage in post-scandal lawsuits to recover improperly-paid compensation. This additional power for shareholders in a derivative lawsuit could also prove as a deterrent for future corruption because of the increased potential for the success of such actions at disgorging ill-gotten gains.

Another means of learning from the abuses that led to the options backdating scandals is to craft compensation frameworks that do not simply reward short-term gains and incentivize timing the volatility of a company's stock price. In this sense, compensation committees and boards should evaluate the downside of traditional options granting compensation and look for ways to encourage long-term value creation for shareholders. Such attempts to make options compensation more consistent with long-term growth by tying options to an average price over a longer period of time, but still maintain the entrepreneurial impetus of options grants, has been suggested by some commentators (Chhabra, 2008). Another suggestion has been to divide the option awards into equal monthly installments and award with basic monthly pay (Narayanan, et al., 2007, p. 1640).

A further way to challenge the ethical failings that led to the backdating scandals is to increase legal enforcement against this and similar types of fraudulent acts. That is, as a prerequisite to stopping future unethical schemes, it is important to recognize that specific infractions have a potential legal and regulatory fix. Examples in the context of backdating include the shortened reporting time requirements that have reduced the timing loophole that

executives had exploited for reporting the date of when options were granted or exercised (Public Company Accounting Reform Act, 2002) and additional disclosure requirements regarding the options pricing on the grant dates established by the Securities and Exchange Commission with17 C.F.R. §§ 239 and 249 (Code of Federal Regulations, 2006).

Another way to create other disincentives to corrupt acts is to promote and reward a self-regulatory framework for corporations that are facing corruption. One approach is to, as a corporate learning and self-regulatory tool, promote the types of "New Governance" principles (hereinafter, New Governance), which are emerging in the Foreign Corrupt Practices Act (FCPA) (1977) enforcement realm. New Governance is an emerging approach to corporate regulation and law enforcement where traditional command-and-control style regulation is replaced with a collaborative governance approach whereby corporations engage in self-regulation to comply with established regulatory goals (Hess and Ford, 2008, pp. 327-330). These developments are described in the recent work of Professors David Hess and Cristie Ford where they have evaluated the increased use of robust self regulation by companies involved in foreign corruption situations. Specifically, Hess and Ford describe the benefits of deferred prosecution agreements among accused companies, the SEC, and the Department of Justice. They critique compliance programs using the New Governance self-regulation framework and conclude that changes to an overall corporate culture of corruption are required for sustained reform (Hess and Ford, 2008, pp. 344-346).

Although Hess and Ford are focused on bribery as regulated under the FCPA, their findings demonstrate the potential usefulness of New Governance self-regulation techniques in reducing ethics violations at the intra-firm level, which could include practices such as options backdating or similar overreaching by executives. For instance, their emphasis on third-party

monitoring to reinforce a company's compliance plan is transferrable to notions of corporate and executive learning from past infractions. It also gives some guidance regarding how a company might work with government regulators in the wake of a scandal to move forward and, perhaps, avoid protracted prosecutions and lower costly fines in exchange for a firm's promise to develop and follow a compliance program. A self-regulatory approach may serve as a useful part of a portfolio of methods to anticipate, detect and remove, and then learn from corruption in the executive suite.

IV. Conclusion

The options backdating scandal is a useful model for illustrating how ethics failures in the executive suite can lead to corruption and financial loss for an organization and its stakeholders. The specific issue of options backdating has seemingly been, at least, partially solved by new accounting and disclosure rules and, hopefully, by the medicinal, sanitizing effects of the sunlight focused on the problem through the press and the public outcry over the scandals. Yet, there is, undoubtedly, the potential for other corporate corruption scandals to arise in the future that will stem from the same tendencies toward greed and breaches of social contracts between executives and their constituents. An understanding of the causes of corrupt options backdating is a useful way to anticipate and address similar future corrupt corporate schemes.

Our framework, which treats these breaches as corruption, includes designing and empowering a proactive ethics committee to: (1) identify and prevent potential ethical lapses, (2) establish mechanisms to detect and eradicate corruption, and (3) learn from past mistakes to prevent future lapses. This approach builds upon Professor Dunfee's work on corruption, as well as Integrative Social Contracts Theory and theories of setting the proper tone from the top. The

themes we advocate, include increasing the accountability of executives, improving integrity, aligning incentives with outcomes, and strengthening shareholder protection, emphasize doing the right thing for the stakeholders. These ethical obligations also stem from the social contract ties that bind executives and their company's stakeholders.[15] It is thus hoped that adoption of this proposal would help firms move toward lasting solutions that can assist in efforts to avoid ethical failings and financial damage in the future by strengthening those ties that bind.

Notes

[1] Another example of Transparency International's expansion into the area of curbing private sector corruption is a recent report it co-sponsored with PricewaterhouseCoopers. The report found that nearly two-thirds of the multinational companies it surveyed faced some form of corruption. The report discusses its definition of corruption this way:

> A definition of corruption: There are many ways to define corruption. Robert B. Zoellick, president of the World Bank, says it is "a cancer that steals from the poor, eats away at governance and moral fiber, and destroys trust" [*citing* World Bank, Press release, "New Report Shows Strong Action in World Bank's Global Anti-Corruption Fight,": Dec. 18, 2007]. For the purposes of this report, corruption is defined as the misuse of entrusted power for private gain and encompasses a variety of issues, including bribery, conflicts of interest, extortion, embezzlement and fraud.

(PricewaterhouseCoopers, 2008, p. 3).

[2] For a discussion of the theory behind granting options, see Jensen and Meckling (1976, p. 323). For an opposing view, see Anabtawi (2005, pp. 1567-1570) for an argument that stock options encourage managers to seek short term gains regardless of high risks.

[3] For a general discussion on the stock options and their incentivizing role see Hall (2000).

[4] For an overview of the backdating scandal, see generally, Narayanan, et al. (2007, p.1598-1605) and Walker (2007).

[5] Hess and Dunfee (2000, p. 595) focus on coarse bribery and define the practice as "the promise or payment of a benefit that induces a public official to breach a duty pertaining to a significant community interest."

[6] This reality also underlies the practicalities of conducting research on corruption. For instance, the anti-corruption NGO Transparency International has recognized that this research is largely limited to measuring perceived levels of corruption in a given country through its well-known annual Corruption Perceptions Index (CPI).

[7] Hess and Dunfee (2000, p. 608). This last point about "ethical imperialism" formed the nucleus of a debate between Hess and Dunfee and Professor Steven Salbu, who argues that a there is a hazard of moral

imperialism when it comes to attacking bribery in the context of various cultures. For further articles on both sides of this debate, see Salbu (2000 and 2001) and Hess and Dunfee (2001).
[8] For the Sullivan Principles and a general discussion of other voluntary codes, see Perez-Lopez, J. (1993).
[9] For example, the government official heading the Corporate Fraud Task Force set up in the wake of the high-profile scandals such as Enron and WorldCom, Deputy Attorney General Paul J. McNulty, described the backdating problem this way:

> Corporate executives who deliberately skew their books to hide compensation expenses are engaged in fraud against shareholders and investors. The president's Corporate Fraud Task Force is committed to investigating and prosecuting those who backdate executive compensation. These investigations represent the next chapter in the Justice Department's fight against corporate corruption. (U.S. Department of Justice, 2007, p. 3).

While discussing the same fraud prosecution related to losses at Monster Worldwide, Inc. one of McNulty's colleagues, U.S. Attorney for the Southern District of New York Michael Garcia, added, "Options backdating is not just a benefit for the employees who get the options. It does real harm to shareholders who are misled about the earnings of the company" (U.S. Department of Justice, 2007, p. 3).
[10] For example, in *United States v Gregory Reyes* (2007) a federal district court found that although backdating was not illegal per se, there was sufficient evidence of fraud for a jury to convict.
[11] For example, in *Aronson v. Lewis* (1984, p. 812) the court stated, "[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence."
[12] In another high-profile executive compensation case, *In re Walt Disney Shareholder Derivative Litigation* (2005, p. 755), the court said, "To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation."
[13] An example of the intersection of the duties was the case of *Stone v. Ritter* (2006, p. 370), where the court held that the duty to act in good faith is encompassed by the duty of loyalty.
[14] For instance, in its opinion section, the *Economist* (2006, p. 15) concluded:

> On the face of it, the mystery is how anyone saw anything but theft in dishonestly using hindsight to date options so that they secretly rewarded their recipients with an instant gain. Yet, this is the anything-used-to-go world of executive share options. When everyone is doing it, perhaps it hardly seems like a crime.

[15] The last conversation Professor Schipani had with Professor Dunfee was after a Bruce Springsteen concert where Mr. Springsteen played his song entitled "Ties that Bind." This song was a favorite of both Professor Dunfee and Professor Schipani. We think of Professor Dunfee often and whenever we hear the song that inspired the title of his groundbreaking book with Professor Donaldson. We miss him and are ever so grateful for his leadership in the field of business ethics, his mentorship, and friendship. There is a hole in our hearts, but he left us with lasting impact in the field of business ethics.

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