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## **Fallacies, Collapses, Crises. Now What?**

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# **Fallacies, Collapses, Crises. Now What?**

## **Abstract**

The current crisis has been seen as the result of a “few bad apples”. The paper argues that the crisis is systemic and based on fallacies and misconceptions in the design and function of the economic – corporate system. Organizational and economic theories are based on hypotheses that lead to faulted decisions on how the system should be regulated and designed.

The paper proposes that a new theory is needed. Disjoint approaches of the current situation are not suitable. Law, Organization theory, Economics, Finance and Accounting need to converge in order to formulate a theory that encompasses all factors and it is holistic. Introduction of corporate governance systems that are as dynamic as the organizational, ownership, product and capital market are, are necessary in order to create a stable and effective corporate environment.

**Keywords:** Crisis, Fallacies, Corporate Collapses, Corporate Governance

## **Introduction**

After the recent scandals, only few scholars and politicians have realized that the old paradigms and practices may not apply any more. Conformist theory scientists believed that the introduction of new laws, regulations and statues was the answer. Sarbanes – Oxley Act and corresponding legal initiatives as well as the new and improved accounting and auditing standards have failed to prevent the emergence of new corporate breakdowns.

The old theories of corporate and organizational structure and behavior have also failed to point out the causes of corporate collapses and to provide analytical tools to remove implementing discrepancies and flaws. The agency theory can't fully interpret the behavior and practices of executive managers in the USA and corporate and organizational structure in Continental Europe. The stakeholder theory is unable to provide a reasonable and acceptable

role to every stakeholder group, in order to justify it. The managerial hegemony theory focuses mainly on the main problem in Anglo-Saxon countries.

Managers are not responsive to any regulatory and legal controls and restraints. Even recently, a bank executive manager has raised his remuneration levels even though his firm had been funded by the U.S. government. Managers are willing to ask for capital from the government but not as willing to be subjected to controls and monitor. Managers of large corporations are forcing the political system, threatening to go bankrupt and hence they create political pressure to bail them out of the crisis.

Market, corporate control and capital, are not as efficient as the theorists hypothesized. Capital markets didn't react at the time and way they were supposed to. Corporate valuations and accounting standards were influenced, one way or the other, by the dominant group (managers). The market for corporate control was based on capital markets, accounting standards and valuation techniques that were mostly based on data provided by auditors and executive managers. Merger and acquisitions seem to be the instrument of empire building or the establishment of wealth maximization illusion. Popular capitalism has failed to diffuse wealth but instead didn't fail to diffuse risk and losses.

Legislators (politicians) have been trying to maintain market and social stability with the help of economists and legal experts. The state has become a major stakeholder providing funds, organizational stability and assurance. The state's intervention goal is to avoid market and trust collapse. Managers and other dominant stakeholders are lobbying to minimize the control and monitor mechanisms the state has established as safety mechanisms for its intervention. On the other hand, the potential gains-rights of the state for providing funds are the same as the ones of a lender and not the ones of a shareholder. The implicit fear of introducing the state as shareholder has increased the pressure to mitigate the state's

participation in firm's equity capital by minimizing the rights and benefits of shareholders. Furthermore, corporations are the largest contributors to election campaigns. A nexus of relations connects executives and major shareholders with political parties and politicians. Politicians have consented to mitigate the rights of the stakeholders that they represent in order to preserve the integrity of the market and hence to serve the greater good. The problem is that this transaction does not fit well in the economic logic.

### **Fallacies**

Corporate governance is not a new notion or issue. It is closely related to the notion of the firm itself, both in time and essence. Corporate Governance notion and theory began with Adam Smith's (1776) "Wealth of Nations". Smith didn't only create the notion but also "predicted" the main problems that preoccupy corporation, governments, shareholders and other stakeholders. Smith (1776) pointed out the agency problem by suggesting that executives that control other people's money should not be expected to show the same diligence as the owners themselves. Furthermore, Smith (1776) described the potential effect that corporate elite may induce on the social and economic well status when he stated that business people "seldom gather together except to conspire against the public interest" (as cited in Turnbull, 2005).

As corporations became larger in size, the dependency of social well being and economic stability on corporations has increased as well. The basic model for the development of corporations has changed. The fundamental entity of the Entrepreneur that had the basic idea for a product or service, initiated production and managed day to day operations isn't the prevailing paradigm. Complexity of today's operational needs, intense competition and the need for capital accumulation has introduced a new paradigm of corporation, where the shareholder, even the founder, has been separated from the control of the firm. Berle and

Means (1932) were the first to create a theoretical framework for the separation of ownership and control. A new player in the corporate game has been introduced: the executive manager. Hellwig (1998) quotes Carl Fürstenberg (1850-1933), a German banker who is even more picturesque, arguing that “shareholders are stupid and impertinent – stupid because they give their money to somebody else without any effective control over what this person is doing with it and impertinent because they ask for a dividend as a reward for their stupidity”.

Three major fallacies in theory formulation can be identified in the literature. The fallacy is not the theory itself but the way it was used to formulate principles, policies and corporate cultures. All theories may serve as good analytical and educational tools. When theory becomes practice without taking into account the social, cultural and political status and dynamics, crisis is the result. As Williamson (2000) argues “reliance by law and economics on the orthodox theory of the firm-as-production function, which is a technological construction, has led to a truncated understanding of economic organization and has resulted in public policy error. Although there are reasons to believe that the worst such errors are behind us, the future will present new puzzles for which public policy error is a lurking concern”. Williamson (2000) made a plea for a new perspective in theory formulation, a perspective that captures and incorporates the full spectrum of dimensions and dynamics of a corporation and an economic system, is more necessary than ever before.

The first fallacy is the one of the efficient market (Fama, 1970, 1991). Since the seminal work of Fama a doctrine has been created. The market itself can solve the problems and create new balance. What Fama introduced in 1970 was not new. Adam Smith had introduced the notion with notion of “invisible hand” of the market. Friedman throughout the 1970s advocated the idea that corporations should be free to do business without any interference from the government. In the next decade this idea was surrogated politically by conservative parties

around the world. President Reagan in one of his speeches has stated that “Government is not the solution to our problem, Government is the problem. ... The societies that achieved the most spectacular broad based progress in the shortest period of time are not the most tightly control, not necessarily the biggest in size or the wealthiest in natural resources. No, what unites them all is their willingness to believe in the magic of the marketplace” (Ronald Reagan, President of United States). And so the deregulation of the markets has found strong political and social support. In some cases it worked. As Jensen, Murphy and Wruck (2004, p. 47) in their study argue, the market for corporate control was effective in solving the problem of undervalued corporations, in the 1970s and 1980s but wasn’t as effective in the case of overvalued corporation in the 1990s.

The term “efficient market” has been used, until recently, even by the most prestigious and influencing organizations, i.e. OECD. OECD (2006, p. 14) supports the idea that the corporate governance framework should promote transparent and efficient markets”. So, according to OECD efficient market is the outcome of good corporate governance and not vice versa. Hence, efficient market may not be the solution by itself. Other prerequisites exist. Corporations and governments should formulate a framework that enhances corporate governance<sup>1</sup>.

The second fallacy is the fallacy of “efficient corporations” or the lack of understanding the inner workings of real firms. According to this notion organizational structure, behaviors, system of delegating power, authority and accountability can change without any costs and instantly just because an efficient structure has been identified elsewhere in the corporate system. The last corporate scandals have proved that corporations can’t / won’t or are not able

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<sup>1</sup> “The only solution to the agency problem of overvalued equity is an effective corporate governance system” (Jensen, Murphy and Wruck, 2004, p. 48)

to adapt to external stimulation so quickly. The fact that many corporations in the USA are still struggling to comply with the Sarbanes-Oxley Act (2002) requirements is an indication for the validity of the previous argument. Through the neoclassical prism of thought, the firm is an integral participant in the market and its existence is dominated by the market. Coase has quite early noted that “the economist does not interest himself in the internal arrangements within organizations but only what happens on the market” (Coase, 1992, p. 714 as cited in Williamson, 2000). Adopting a monolith approach to a multidimensional problem is a very bad start to have a sufficiently adequate solution. Kaplan and Norton (1992) (their four example perspectives are: financial, customer, internal business process, and learning and growth) have captured the notion that a complex organization with many stakeholders and equally many interests and goals needs a multidimensional performance measure. A firm, in order to be efficient, must address issues that are outside the norms of monolithic economic and managerial thought. A firm is an entity that has to coexist and develop in a market and in a society. A firm has to adopt more complex behavioral patterns and become political in the Aristotelian sense. The market is as complex as the firms and stakeholders that participate in it. Firms and stakeholders must adopt adequate solutions to deal with the complexity of the market. The efficient corporation is a corporation that takes into account all factors of the market and the society in which it is active.

A third fallacy is that the neoclassic theory, although preoccupied with consumer behavior, has abolished in its theoretical perspective, the dynamic and sometimes irrational (or not covered by any behavioral theory) nature of human behavior and also the dynamics that is developed in the interaction of people with the social, economic and political system. The basic assumption of the neoclassical theory is that human behavior can change instantly because people are homo economicus and individuals adapt to a more efficient behavior or react and adapt to an external stimulus. The problem is systemic (Kirkpatrick, 2009). Jensen,

Murphy and Wruck (2004, p. 44) have put one's finger into the print of the nails arguing that "before we can "solve" current problems we must be sure we understand their root cause. The root cause was not that many executives suddenly decided to be crooks, but rather lies with the system in which they are working".

All three fallacies are in essence one. Market, corporations and human beings are perceived as entities with only one goal and that goal is wealth maximization. This approach is based on the hyper rationalization assumption out of which orthodox economics works (see the work of Simon, 1985). A quantifiable and easy to comprehend, and hence rational, goal is wealth maximization. Aristotle's philosophy considers wealth as an inferior goal and that well-being or happiness is the ultimate goal. Adam Smith thought that well-being may be the result of the pursuit of wealth. The prerequisites for Smith's and Aristotle's perception of economy are the existence of perfect markets, socialized participants, implicit political and governance procedures and, finally the Aristotelian notion of order. Politics, ethics and economy are interlaced and interconnected.

Politics and ethics play a more crucial role in a market that is mainly dominated by oligopolies and cartels. Today's market has a growing presence of cartels and oligopolies. The history of deregulation is evidence of the political power of corporations and economic power.

The notion of shareholder is not as clear as the literature suggests. A fuzzy line of ownership exists. It is not always so easy to detect the real owner of a share or the owner of a financial product to detect the firms that the fund, bank or firm has invested in. Accountability, responsibility and transparency principles of corporate governance (Klapper and Love, 2004) are difficult to implement if one of the main subjects, focal points or stakeholder of corporate governance is difficult to specify or determine. Ownership fuzziness creates an inner

environment that facilitates the dominance of the controlling party and minimizes the probability of monitor and control.

Both main corporate governance theories (agency and stakeholder) focus on the firm – shareholder. Stakeholder theory recognizes the state as a stakeholder but doesn't describe a role, function or rights and responsibilities of the state. Society and the state are the ones that were called to buy – out many firms and banks during the current crisis. A problem with the state as a stakeholder is that the firm may be multinational and hence borderless, whereas the state has borders. Which state should pay for the survival of the firm?. A second problem is that a citizen can't exert monitor and control because he is not identified as a legitimate shareholder – stakeholder.

### **Corporate Collapses - Failures**

There is a mistaken cognizance of the time and situations needed that lead to corporate collapses. “Failure does not happen suddenly..., problems build up and intensify, causing the organization to finally lapse into systemic failure” (Choo, 2008). Corporations do not fail because there are some “bad apples” (Davis, Payne and McMahan, 2007) or suddenly. They fail due to bad leadership, unethical behavior and market's inefficiencies or flaws (i.e. oligopolies). Due to previously mentioned theoretical fallacies, collapses and failures cannot be fully explained by the existing dominant theories, like the agency theory. The neoclassical notion that executive remuneration and prices can create internal (corporate) and external (market) equilibrium simply failed.

The current crisis is interconnected with the crisis of the corporate governance system. Corporate governance fallacies and failures have functioned as catalyst to speed up or to amplify the financial crisis and its consequences (Kirkpatrick, 2009). Current corporate governance systems relinquish diffused shareholders without sufficient information for the

risk that the firm is taking while pursuing high performance and without a well perceived and calculated valuation of the firm (Dong, et al., 2006; Shleifer and Vishny, 2003).

Both main corporate governance mechanisms (monitor & control and alignment incentives) failed to provide or to assure a stable and functional framework for the corporations. Board of Directors members, committee members, auditors, legislators, lawyers, accountants didn't or wouldn't or couldn't fulfill their fiduciary duties. Their failure had some factual causes. The corporate world is very complex and fast. The complexity and speed is increasing as time passes by. These people didn't have the time, resources or even the knowledge and skills to comprehend and maneuver in this complex corporate environment. Many of them, probably due to their self confidence in their past, abilities and achievements, didn't evaluate and take into account the systemic risk. Furthermore, the agency problem created an asymmetry of performance horizon, over-investment and the illusion of perpetual high performance. Managers had a short term horizon and shareholders (at least for majority of them) a long term horizon. Managers may act as free riders, while shareholders due to false or distorted information were left to have a distorted notion for the firm's valuation and prospect.

Corporations are microsocieties (Winjnberg, 2000, p. 334) whereas markets are an integral part of the society in general. Dierksmeier and Pirson (2009) study Aristotle's contribution to the current crisis and economic theory. They argue that "it has been in the comparatively short time-span from 1800 to date alone that economics has aspired and (to some degree) managed to sever itself from its cultural embedding and from its intellectual moorings in political philosophy". Aristotle argued that politics is the essential element of every society or group of people. In order for the society to be, a system of governance must be created and politics within the system needs to be applied. Within this political system, executive managers (in the Anglo-Saxon system of corporate governance) and major shareholders (in the Continental

Europe system of corporate governance) are leaders with fiduciary duties. Some researchers propose that executives should be paid as bureaucrats (Frey and Osterloh, 2004). Contrary to the argument of Frey and Osterloh (2004), managers must not be paid as bureaucrats or even as value optimizers because, above all, they are leaders and political personalities with the fiduciary duty to protect the interests of the micro-society called corporation and to create institutions, mechanisms and culture that serve these interests.

It is no surprise that, even now (mid 2009), there is evidence that many executives pander to the system's inefficiencies in order to retain or increase their remuneration levels, even though their corporations are failing or are in distress. Crisis and deviant behavior is the aftermath of systemic failure and fallacies in its design.

### **Crisis**

Two hundred years of corporate development haven't solved the problems of corporate goal determination (Jensen, Murphy and Wruck, 2004), ethics, incomplete contracts and asset/wealth distribution. In the last thirty years a large number of theories or theory groups have been formulated (for the main theories see Table 1) to address the issues of corporate governance. It is no coincidence that each theory group has occurred after an economic crisis or economic boom. This is an indication that crises and abnormal economic activity are a good incentive for theory formulation and fallacy detection.

**Table 1. Main Theories of Corporate Governance**

<b>Theory</b>	<b>Main scholars and references</b>	<b>Main concern - hypothesis</b>	<b>Crisis<sup>2</sup></b>
Agency theory	Berle and Means (1932) Jensen and Meckling (1976)	Separation of ownership and control, principal – agent relation – conflict of interests	1929-1932 1972
Managerial hegemony theory	Mace (1971) Vance (1983) Lorsch and MacIver (1989)	Board of Directors are a legal fiction dominated by management	1978
Stakeholder theory	Stanford Research Institute (1963) Freeman (1984) Donaldson, T. & Preston, L. (1995) Vinten (2000, 2001)	A firm should be run in the interests of all its stakeholders rather than just the shareholders.	1980
Stewardship theory	Donaldson (1990) Davis et al. (1997) Muth and Donaldson (1998)	Managers are motivated by “a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby gain recognition from peers and bosses”	Asian crisis 1997
Resource dependence theory	Pfeffer, 1972, 1973; Pfeffer and Salancik, 1978; Pearce and Zahra, 1991; Goodstein et al., 1994	Focuses on the role of interlocking directorates in linking firms to both competitors and other stakeholders (Zahra and Pearce, 1989)	1972, 1978

<sup>2</sup> A short list of some major financial crises since 20th century

- 1910 – Shanghai rubber stock market crisis
- 1930s – The Great Depression – the largest and most important economic depression in the 20th century
- 1973 – 1973 oil crisis – oil prices soared, causing the 1973–1974 stock market crash
- 1980s – Latin American debt crisis – beginning in Mexico
- 1987 – Black Monday (1987) – the largest one-day percentage decline in stock market history
- 1989-91 – United States Savings & Loan crisis
- 1990s – Japanese asset price bubble collapsed
- 1992-93 – Black Wednesday – speculative attacks on currencies in the European Exchange Rate Mechanism
- 1994-95 – 1994 economic crisis in Mexico – speculative attack and default on Mexican debt
- 1997-98 – 1997 Asian Financial Crisis – devaluations and banking crises across Asia
- 2007-09 – The American financial crisis of 2007–2009 helped create the global financial crisis of 2008–2009, thus creating the late 2000s recession.

What is very interesting is that for the current crisis, no theory has been formulated yet. The old theories can't explain the magnitude and spread of the current crisis. Purely economic, financial, legal and/or political causes failed to establish a good and reasonable causal relation to the crisis's phenomena. The main reason is that the crisis is the result of a crisis in the educational, ethical, cultural and political level of the organized societies. Corporate governance system's inelasticity may tamper with competition and reduce the effectiveness of any initiatives (legal – mandatory or voluntary) and acts as a factor of problem accumulation (Kirkpatrick, 2009).

The first battle of the current crisis has been given and lost in the classrooms of universities in the 1970's and 1980's. The prevailing theories and ideology has been formulated as agency and stewardship theory. Executives and professionals have been nominated as guardians of other people's property, regardless Smith's two hundred years warnings and suggestions. The second battle has been fought on the political level. The stake was the formulation and justification of the market's deregulation and the liberalization theory. While promoting free markets, oligopolies were formulated and political influence of corporations was increased dramatically. Corporations may dictate, more or less, the legal environment, especially in the common law countries. Legal initiatives like Sarbanes – Oxley Act in USA, although in the right direction have been challenged by major corporations (see Quinn, 2008; <http://www.insidesarbanesoxley.com/2007/03/judge-dismisses-sarbanes-oxley-lawsuit.html>) and by activists that argue that the impact of the law is weak. It is true that Sarbanes – Oxley Act in the USA wasn't able to prevent the 2008 corporate collapses.

### **Now What?**

Since the outbreak of the current crisis a new theory is needed. Disjoint approaches of the current situation are not suitable. Law and Organization theory, Economics, Finance and

Accounting need to converge in order to formulate a theory that encompasses all factors and is holistic. Until now the observable speed of behavior for people, corporations, markets and states has been slow. In the last fifteen years globalization and information technology have reduced product life cycle, expectations, response time to external stimuli, production time and capital and product circulation speed. Turbulent and complex inner and outer environment are difficult to comprehend and control. Managers' advertised abilities to lead corporations under distress and complexity to success were the motive for shareholders to hire them. Shareholders were willing to lose control over the expectation of capital returns and minimized cost of monitor and control. They lost their initial function and distanced themselves even from the company they had provided with capital.

Deregulation and managers' - major shareholders' unchallenged empowerment have led to the loosening of the bonds of shareholders with their corporations. Shareholders ceased to be members of the corporate micro-society and participants in the "political" processes. They became members of the outer environment. As non members of the micro-society any interest regarding the corporation's procedures and corporate politics is diminished. Static corporate governance systems have induced this shareholders' inertness. Kirkpatrick (2009) proposes the introduction of corporate governance systems that are as dynamic as the organizational, ownership, product and capital market are.

## **Conclusions**

The current crisis is neither the outcome of a "few bad apples" nor the aftermath of a glitch in the system. Fallacies in the system's "design" have created the substratum of corporate collapses and failures. No new theory has been formulated to address the issues and problems that the crisis has revealed. The old theories were developed during the last 30-40 years and their explanatory power has been weakened by their bias to a specific group of stakeholders

and the non holistic view and approach. The world's economy and corporations can't afford academic, systemic and theory myopia. There is a need for the introduction of a new holistic theory that encompasses all relevant branches of science. Furthermore, the introduction of a dynamic corporate governance system is critical to the stability of the corporate system and the market itself. The system must address the issues of ethics and human behavior in general as well as the organizational and market structure issues.

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