Corporate Culture

Class #3

UC Berkeley School of Law

Professor Grennan

Test Your Knowledge of Class #2

True of False

1. Cultural values are an articulation of what the company values and what leaders hope employees will aspire to be.

2. Culture is something that requires an investment of time and money and will need to be iterated and updated over time.

3. “Cultural recipes” are paradigms with prescribed cultural values but there is no evidence that these recipes work.

4. Cultural values have an opposite (e.g., harmony vs. competition) and should be balanced or framed (i.e., put a positive spin on the value if it can be viewed as a loss) for the less-desirable values.

5. Investors often do not fully recognize the value of culture. One reason is that the aspirational or stated values are often different than the lived values everyday.

Linking classes #1 through #3

- So far we have emphasized the importance of perspective (i.e., that different people have different assumptions and biases), so they need a focal point to direct their activity and attention toward.

- We learned that cultural values are aspirations that executives hope to focus employee attention on. But there is no universally optimal culture, rather it is firm-specific and can be determined by considering trade-offs between various aspirations.

- Today, we will focus on the conception of culture as an informal institution consisting of values and norms that interact with formal institutions. We will explore how these formal systems reinforce or work against the culture.

Outline of Class #3

- Defining formal and informal institutions
- What is the relationship between formal and informal institutions?
  - Markets and morals
  - Shareholder governance and culture
  - Promotion and the Peter Principle
  - Intrinsic vs. extrinsic motivation and the role of incentive pay
  - Corporate law and nonlegally enforceable rules and standards

Reflection

Take a moment to think and raise hand to share.

Your client, a publicly traded company outside the U.S., is based in a country known for corruption.

They are seeking your advice about cross-listing their stock on the NYSE. They think a cross-listing would assure their investors that their firm aspires to a high level of integrity and takes ethics seriously. Would you advise your client to cross-list? Why or why not?

Corporate Culture: Formal and Informal Institutions

Douglas North – Institutions

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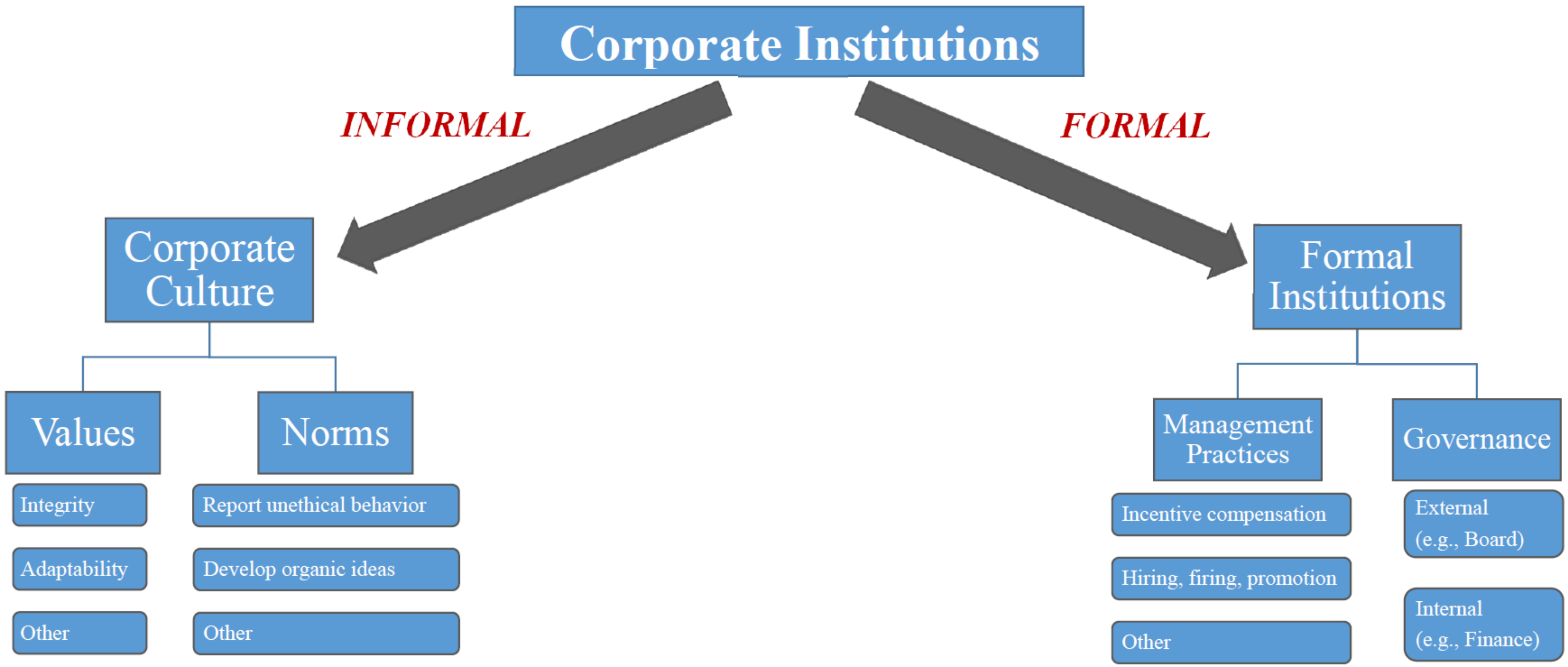
- Institutions are humanly devised constraints that structure political, economic and social interaction.

- Institutions are composed of two branches:
  - Informal constraints (e.g., taboos, norms, etc.)
  - Formal rules (e.g., law, property rights, etc.)

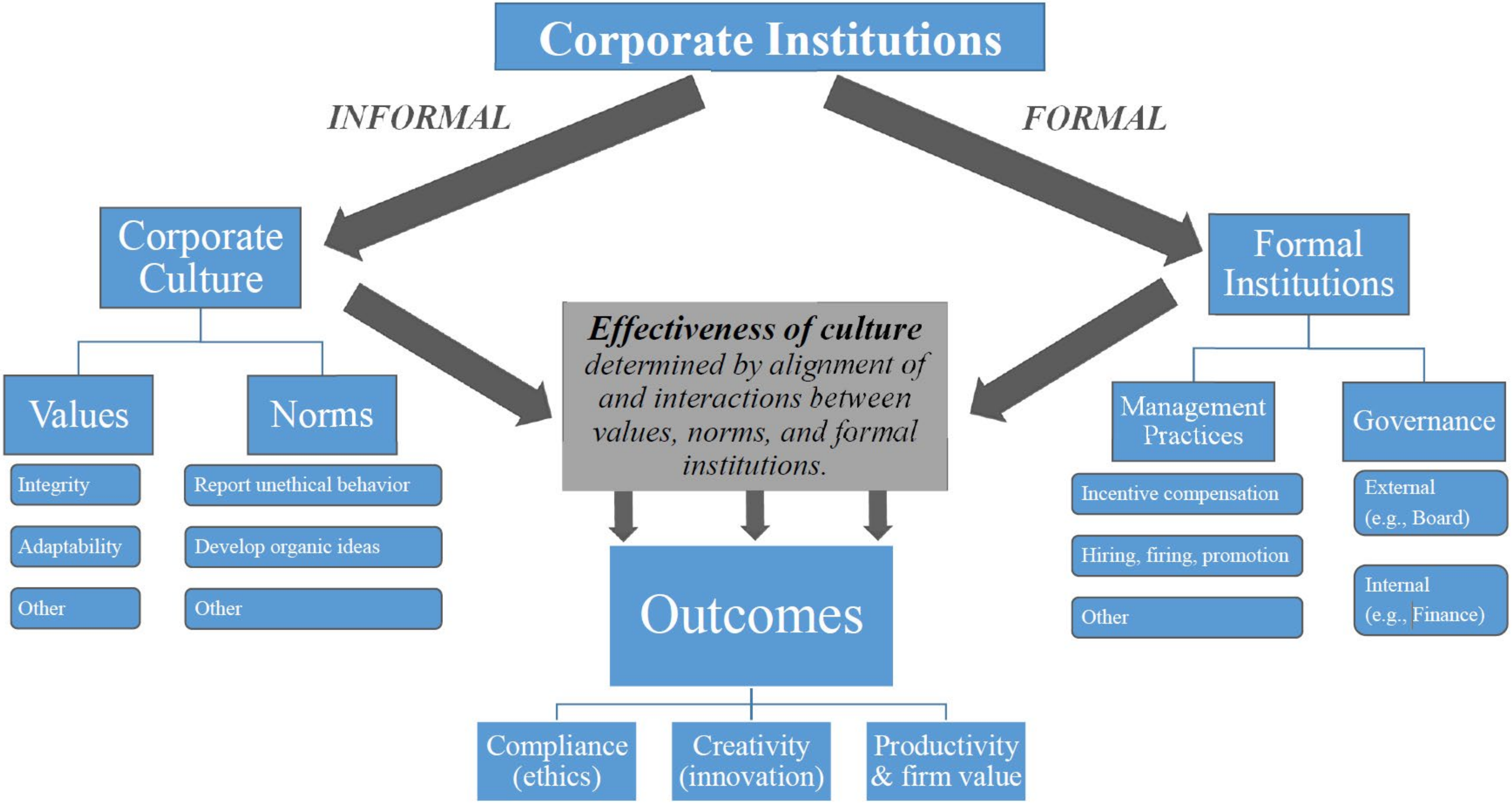
- Institutions create order and reduce uncertainty in exchange by providing an incentive structure.

- As the structure of institutions evolve, it shapes the direction of economic activity towards growth, stagnation, or decline.

Culture as an Informal Institution



Reinforced by Formal Institutions



Class #1: Textbook Culture Definition

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Culture is the pattern of behavior that is reinforced by systems and people. It is manifest in the norms or expectations that people have for how they need to behave to fit in and succeed in the organization.

Culture Is Reinforced by Formal Institutions (Systems). What Systems?

- Markets
- Regulations, laws, and rules
- Investors and corporate governance rules
- Human resources practices
- Management practices
- Finance team
- Lawyers and compliance team
- Outside stakeholders: community, customers, investors
- Etc…

Corporate Culture: Morals and Markets

Do Markets Change Moral Values?

- Almost anything can be bought and sold, but you are unlikely to buy love or friendship.
- Does that fact have something to do with your moral or cultural values?
- Does the act of simply exchanging a good (or putting a dollar value on the good) in a market place change your moral view of it? Why or why not?

Do Markets Erode Moral Values?

Hypothesis that people who participate in markets (i.e., buy or sell a good) seem to act against their own morals. Why might markets erode morals?

1. It takes two people to complete a trade, so **negative consequences are shared** (e.g., guilt) and potentially diminished.
2. Market interaction reveals **cultural norms**. Observing others trading and ignoring moral standards may make the pursuit of self-interest ethically permissible.
3. The mere existence of a market may provide **social information** about the appropriateness of the good or service being sold.
4. Markets provide a strong **framing** and focus on materialistic aspects such as bargaining, negotiation, and competition, and may divert attention from possible adverse consequences and moral implications.

The Mouse Experiment

Ideal experiment: have a moral judgement and then randomize the person making the decision to various markets.

Lab experiment: moral judgment is about killing a lab mice.

Baseline kill rate: Participants not in market but are given option A or option B. With option A, they receive $20 but mouse dies. In option B, they receive no money but mouse survives. Roughly, <u>**46% choose money over mouse**</u>.

The Mouse Experiment (2)

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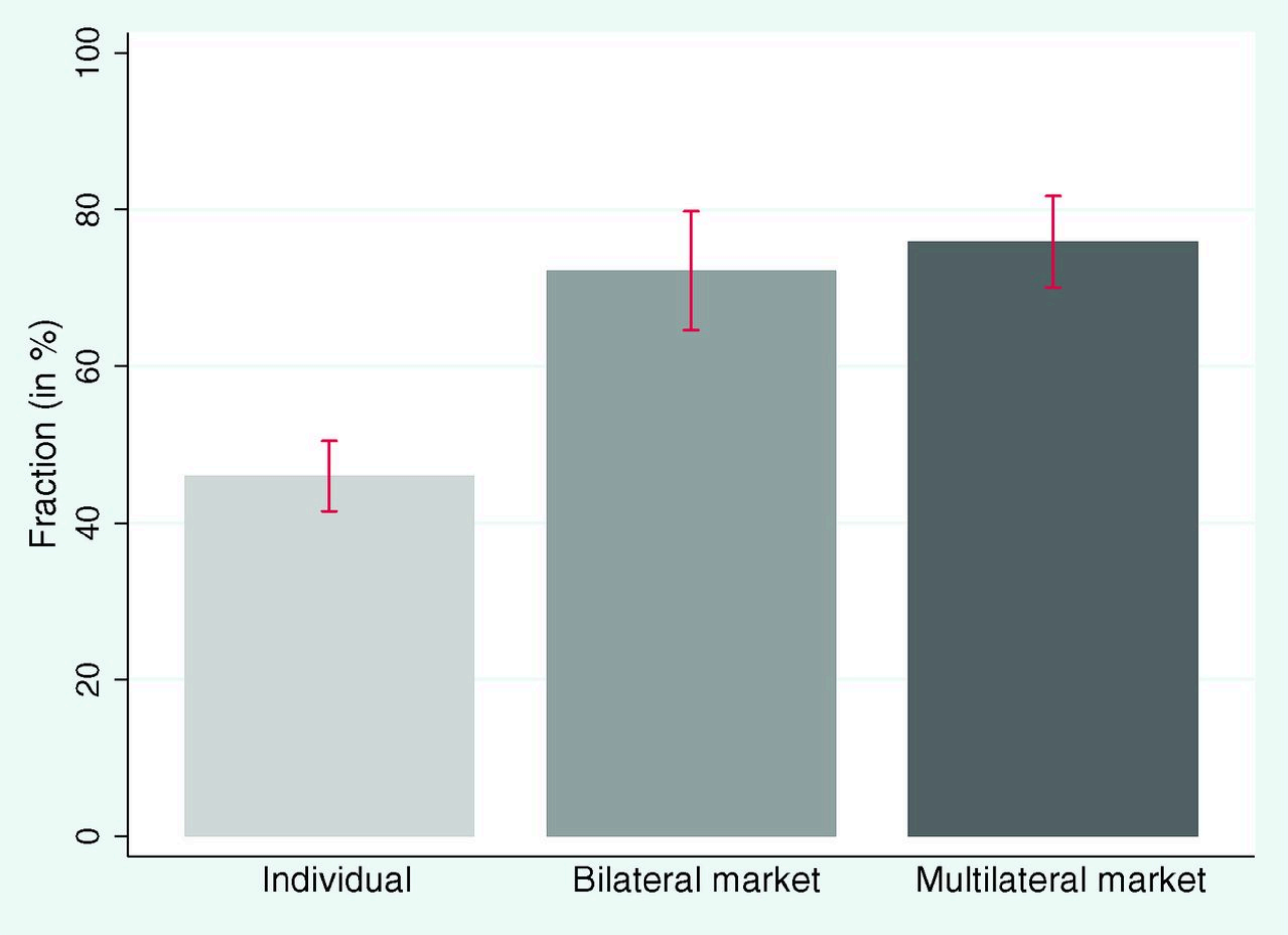
Two people: one seller and one buyer. The seller was given a mouse and explicitly told that the “life of the mouse is entrusted to your care.” If a buyer and a seller agreed on a trade, the buyer received $40 minus the price agreed upon. The seller received the price but the mouse was killed. If a seller or a buyer did not trade, $0 but the mouse survived.

Market setting: Just like the two people but now multiple buyers and sellers and could take offers from multiple parties.

Main Finding: Markets Erode Morals



Internal Markets and Morals

Take a moment to think and respond.

Clorox owns Burt's Bees. They rotate new executives through Burt's Bees for 6 months.

Question: Can these internal market experiences enhance morals? Why or why not?

Corporate Culture #3: Governance and Culture

Shareholder Activism

Question #1: What are activist hedge funds? What are their goals?

Question #2: Should firms defend against activist shareholders? Why or why not?

Bebchuk vs. Lipton

Berkeley Law

Lucian Bebchuk: activists increase returns to shareholders so they should be able to control the material decisions of companies.

> **Key evidence:** Almost every activist attack, or even rumor of an attack, by these hedge funds will result in an immediate increase in the stock market price of the target.

Marty Lipton: activists destroy value. Gains to activists are short-lived and come at the expense of long-term value. Activists also hurt the firms not under attack because those firms adopt strategies to avoid becoming targets (e.g., aggressive accounting practices). All of this hurts the American economy and people.

More Myths from Lucian Bebchuk

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Tuesday, August 24, 2021

Two years ago, the Business Roundtable (BRT) issued a "Statement on the Purpose of a Corporation," signed by the CEOs of 184 major U.S. corporations, that rejected shareholder primacy, declared "a fundamental commitment to all [corporate] stakeholders" and linked corporate purpose to advancing and protecting the interests not just of shareholders, but of all corporate stakeholders. The BRT's statement reflected rapidly growing momentum towards a more inclusive corporate governance regime and promised to accelerate stakeholder governance by committing business leaders to the interests of employees, customers, suppliers, communities and the environment.

The BRT statement elevated the topic of stakeholder capitalism to the top of national and global policy debate. In 2020, the World Economic Forum launched the new "Davos Manifesto" in support of stakeholder capitalism. Nearly every significant asset manager—including the "big three," BlackRock, Vanguard and State Street—now insists that the companies in which they invest adopt sustainable stakeholder governance practices. At the urging of their investors, large companies are nearly uniformly undertaking efforts to make and measure progress in achieving sustainable, socially responsible operations. The signs of the step-up in the embrace of stakeholder governance by corporations and their major investors are everywhere.

This month, however, Lucian Bebchuk of the Harvard Law School published and then publicized an article claiming to demonstrate that the entire BRT exercise, and all the efforts that preceded and followed it to advance stakeholder governance, were "mostly for show." After reviewing a "hand-collected" set of corporate policy documents created by BRT signatories over the past two years, Bebchuk and a collaborator declared they saw little evidence that those documents had been recently revised to follow through on the BRT statement. From this self-proclaimed exercise in "empirical investigation," Bebchuk concluded that the BRT statement and allied initiatives to advance stakeholder governance are "ineffective and counterproductive."

Activism and Value: The Evidence

Inconclusive and nuanced

- Equity markets – descriptive statistics show activism creates value and activists hold for the long-term but many critiques of the sample, etc…
- Manufacturing plants – probably best piece of evidence, positive but industry specific and based on “matching”
- Innovation – inconclusive given timing of R&D and basis on “matching”
- Investment cycle – descriptive statistics show activism hurts value
- Bond markets – descriptive statistics show activism hurts value

What’s missing that could resolve these differences?

Reading for this week “A Corporate Culture Channel: How Increased Shareholder Governance Reduces Firm Value” argues culture is missing.

Activism and Culture

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Quote from CFO interviews about shareholders:

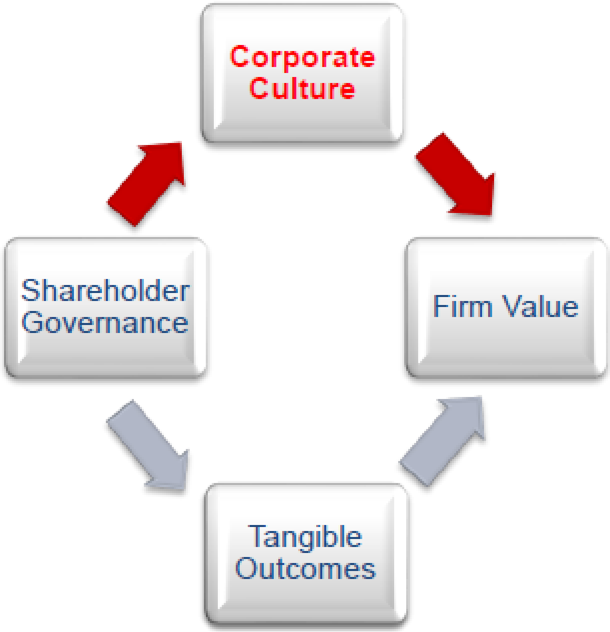
“At my current firm, we have the benefit of trying to say "let's try to make positive investments" because we have an owner who is the ultimate long-term shareholder.

At my previous firm, I worried more about managing the stock price. I had to worry about hedge fund activists. I don't think activists are about long-term value maximization. Those guys just want to come in and make some changes, get a transaction done, and make some profits within a year. I think you worry about this, if you have bad performance, you can get an activist and they can really just change your life.

I do think <u>culture matters in the attitude on quarterly earnings and how much stock price matters</u>. I do think the nature of public shareholders, it almost gets political sometimes, and the pressures that comes there and activism that comes there matters for the attitude.”

Does Shareholder Governance Affect Value, If So How?

Are intangibles, such as corporate culture, significant transmission mechanisms for the governance-value link?



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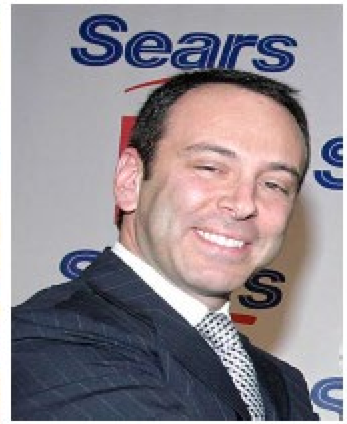
"Multitasking" Trade-off Between Easy-to-Observe and Hard-to-Measure



"Lampert's model creates a warring tribes culture. Cooperation and collaboration aren't there. The result is confusing to the customer."
– **Employee at Sears, 2012**

Approach in “Culture Channel”

- Quantify corporate culture using text-based analyses.
- Develop predictions grounded in multi-tasking theory.
- Address endogeneity among governance, culture, and value
  - Exploit close-call votes on pro-shareholder governance reforms to estimate impact of governance on culture.
  - Extend research design to separate impact on firm value via a corporate culture channel from a traditional tangible channel.
  - Explore effect of heterogeneity in pre governance reform cultures to determine potential policy implications.

Approach in “Culture Channel”

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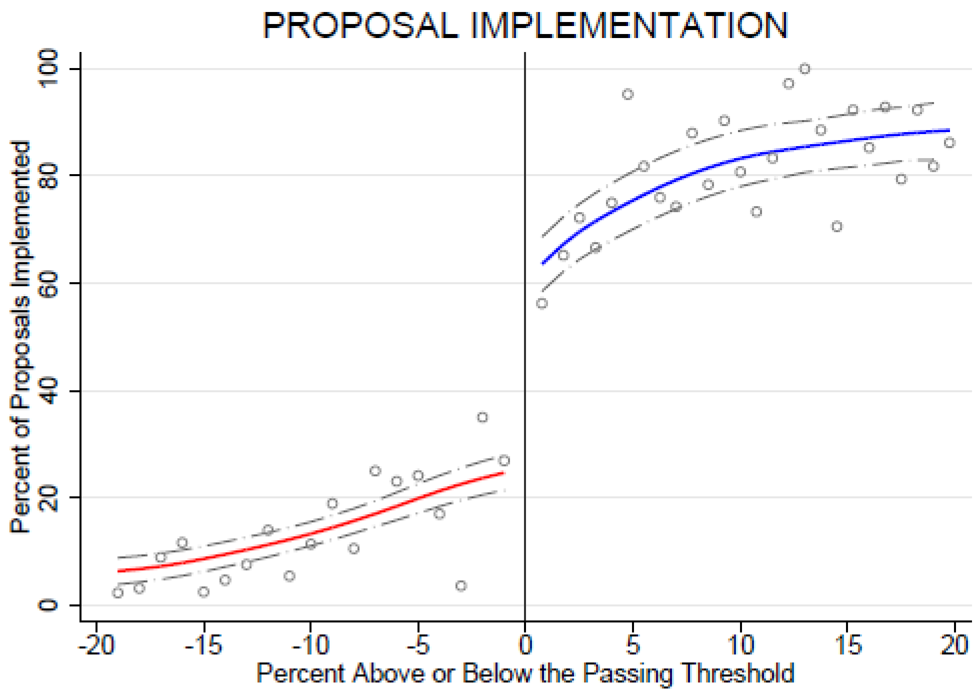
Compare firms just below and just above proposal threshold



Discontinuity in Employees Perceptions of Culture Afterward

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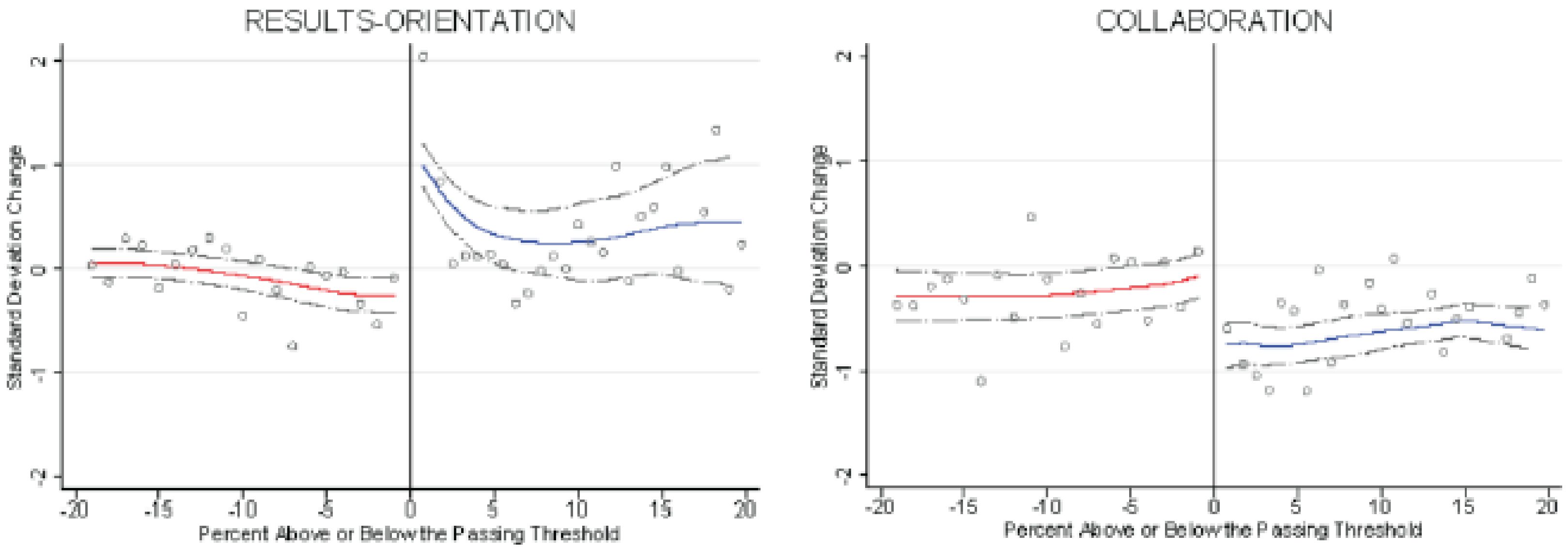

Does Change in Culture Link to Change in Firm Value?

- Short-term – significant increases in sales growth, profitability, and payout.
- Long-term – significant declines in intangible assets, goodwill, customer satisfaction, and brand value.
- The gains in easy-to-observe performance metrics erode and the losses from the harder-to-value intangibles dominate after 3 years.
- Stock market appears to recognize the trade-off even on the event day between the tangible and intangible channel but not fully.

Potential Policy – Only Target Firms with Low Results-orientation

- Is shareholder governance one size fits all?

- Examine heterogeneity in starting cultures for policy implications.
  - Firms that were already in the upper 1/3 of the results-orientation distribution do not see gains in firm value from strengthening governance, even in the short term.
  - But all firms, suffer to some extent from declines in collaboration, integrity, and customer-focus after an increase in governance.
  - On net, this suggests target firms with low results-orientation to enhance firm value.

Conclusion: Culture Is Key Part of Governance-Value Link

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- Culture is an economically important transmission mechanism between governance and firm value.
- On average, CEOs trade-off easy-to-observe performance metrics with difficult-to-measure intangibles.
- The firm value declines via a corporate culture channel suggest shareholder vs. director-centric governance is not black and white and governance is not one size fits all.

Jillian

PE and Culture-Value Link?

Challenge: revive a 60-year old burger chain

Solution? Private equity (PE)?

Typical PE approach is to cut costs, layoff workers, invest in technology/automation, discipline remaining executives with lots of debt, and then generate massive returns.

Question: Are the effects of PE on firms going to be similar to shareholder activism, why or why not?

Are There Cultural Consequences?

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FOOD & BEVERAGE

How 3G Capital and a $50B buyout turned Kraft Heinz upside down

Since 2013, more than 10,000 people — one-fifth of the workforce — have been laid off from Kraft and Heinz, with seven plants shut, highlighting the human cost and upheaval involved in producing the highest profit margins in the food industry. The founders of 3G have transformed the beer, fast food and food manufacturing industries with bold acquisitions, which are quickly followed by a brutal but disciplined attack on costs, a surge in profitability and high returns to shareholders.

"If I go to another job I have to start from the beginning again," says Juan Perez, who has worked for nearly two decades at Kraft's Oscar Mayer factory in Madison, Wisconsin. "It's like wasting 18 years."

How Might We Want to Assess The Pros and Cons of PE?

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- What is the goal of the firm? What is the horizon for this goal? Is it short-term or long-term?

- If PE delivers greater profit in the short-term through layoffs and cost cutting will this de-motivate the workers currently working there? Why or why not?

- Which workers are mostly likely to stay and which workers are likely to leave?

- What other challenges will PE execs face?

Corporate Culture #3: Human Resources and Culture: Promotions

Human Resources and People Development

In the last thirty years, human resources moved from the idea that each firm was unique and required idiosyncratic solutions, to the idea that firms are actually quite similar. These means generalizations and “best practices” can be learned from comparisons across firms.

The job of human resources is to:

1. Hire
2. Train and on-board
3. Fire and promote
4. Compensation and benefits
5. Performance monitoring and feedback

Human Resources Helps To Answer

- Why should pay vary across workers within firms—and how “compressed” should pay be within firms?
- Should firms pay workers for their performance on the job or for their skills or hours of work?
- How are pay and promotions structured across jobs to induce optimal effort from employees?
- Why do firms use teams and how are teams used most effectively?
- How should all these human resource management practices, from incentive pay to teamwork, be combined within firms?
- What should training and mentoring programs look like, and how frequently should they occur?

Promotions

- Big questions
  - Who gets promoted and why?
  - What determines pay after the promotion?

- The "**Peter Principle**" was first described by Lawrence Peter in his 1969 book. It states that people are continually promoted within an organization until they reach their level of incompetence.

- What is your reaction to the Peter Principle? Does it seem realistic? Why might firms benefit from using the Peter Principle?

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Promotions and the Peter Principle*

Alan Benson, Danielle Li, Kelly Shue

The Quarterly Journal of Economics, Volume 134, Issue 4, November 2019, Pages 2085–2134, https://doi.org/10.1093/qje/qjz022

Published: 16 August 2019

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Abstract

The best worker is not always the best candidate for manager. In these cases, do firms promote the best potential manager or the best worker in their current job? Using microdata on the performance of sales workers at 131 firms, we find evidence consistent with the Peter Principle, which proposes that firms prioritize current job performance in promotion decisions at the expense of other observable characteristics that better predict managerial performance. We estimate that the costs of promoting workers with lower managerial potential are high, suggesting either that firms are making inefficient promotion decisions or that the benefits of promotion-based incentives are great enough to justify the costs of managerial mismatch. We find that firms manage the costs of the Peter Principle by placing less weight on sales performance in promotion decisions when managerial roles entail greater responsibility and when frontline workers are incentivized by strong pay for performance.

Rising to Your Level of Misery at Work

By Arthur C. Brooks

EVERYONE has heard of the Peter Principle: Managers rise to the level of their incompetence. Today, however, a whole class of hyper-competent Americans will never find their level of incompetence. Instead, they will suffer a similar principle in which they rise to their level of misery.

Here's how it works: Ambitious, hard-working, well-trained professionals are lifted by superiors to levels of increasing prestige and responsibility. This is fun and exciting — until it isn't.

People generally have a "bliss zone," a window of creative work and responsibility to match their skills and passions. But then the problems start. Those who love being part of teams and creative processes are promoted to management. Happy engineers become stressed-out supervisors. Writers find themselves in charge of other writers and haranguing them over deadlines. In my years in academia, I saw happy professors become bitter deans, constantly reminiscing about the old days doing cutting-edge research and teaching the classes they loved.

Could Dual-Purpose Alleviate Misery?

What Other Benefits or HR Type of Changes Could Alleviate the Misery?

Many people who work at Patagonia are passionate about spending time in the outdoors, as well as protecting it. The company offers employees the ability to do just that through the Environmental Internship Program. Employees from all parts of the company are allowed up to two months away from their regular roles to work for the environmental group of their choice while continuing to earn their paycheck and benefits. This year, 34 individuals, 12 stores and one department took advantage of this program –putting in almost 10,000 volunteer hours for 43 organizations.

For small, grassroots groups working in local communities, having a free Patagonia employee intern is a huge help. And when interns return, they bring back stories, inspiration and a new commitment to our environmental mission.

Promotions and Tournament Theory

- "Winner take all" tournaments are competitions between peers to achieve a promotion to a higher rank along with the pay and perks that go with it.
- The point is promotions are a relative gain.
    - Individuals are promoted not on the basis of their absolute performance, but on the basis of their relative position in the organization.
    - The compensation at one level does not necessarily serve to motivate individuals currently at that level, but instead to motivate all of those below that level who strive to be promoted.
    - Overall, the larger the jump up in pay, the more effort will be made. But there is an optimal jump up: too much jump creates recruitment and cooperation problems.

Bad Boss Traits

Corporate Culture #3: Human Resources and Culture: Incentive Pay

A Traditional HR View

The profit-maximizing firm's theory of motivation assumes:

1. **Effort aversion:** people will not expend effort unless paid to do so)
2. **Opportunism:** people, in the pursuit of their own interests, will often misrepresent their true preferences and engage in guile and deceit
3. **Goal disagreement**: employees in organizations have different agendas than the owners and therefore incentives need to be designed to force people to do what is right for the good of the organization.

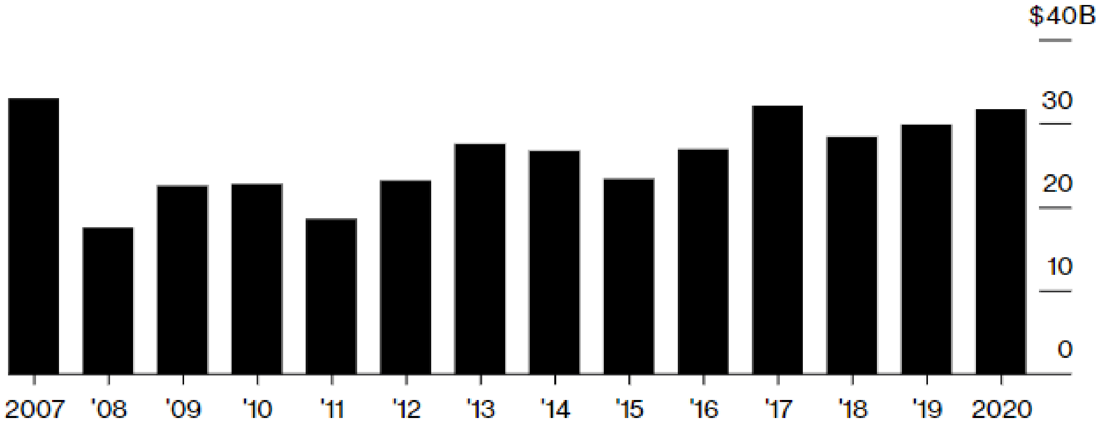
Given that people are assumed to be lazy, dishonest, and at odds with the goals of the managers, firm must incentivize.

Reflection

Take a moment to think and raise your hand.

Question: Does incentive pay work? If so, in what context and when?

Goldman Trading Bonus May Jump Nearly 20% After Year's Windfall



The average Wall Street bonus climbed 10% last year as the coronavirus pandemic fueled market volatility and a surge in underwriting.

The typical bonus paid to employees in New York's securities industry climbed to $184,000, according to calculations by New York State

Performance Pay in Theory

Output sometimes difficult to measure

- Complex tasks
- Team projects
- Takes time to play out (R&D)
- Output highly variable (risky projects)

When measurement risk is an issue, pay on input (i.e., hourly wage, salary, etc..)

- Input imperfect but often more available measure of what is desired
- Input is thought to not distort behavior

A European Issue

- If termination is difficult, suggests using hourly and some pay on output system (i.e., commission)

Intrinsic vs. Extrinsic Motivation

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Asks what impact empowerment and monitoring have on employees' morale and productivity?

Intrinsic and Extrinsic Motivation

Roland Bénabou, Jean Tirole

The Review of Economic Studies, Volume 70, Issue 3, July 2003, Pages 489–520, https://doi.org/10.1111/1467-937X.00253

Published: 01 July 2003 **Article history** ▾

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Abstract

A central tenet of economics is that individuals respond to incentives. For psychologists and sociologists, in contrast, rewards and punishments are often counterproductive, because they undermine "intrinsic motivation". We reconcile these two views, showing how performance incentives offered by an informed principal (manager, teacher, parent) can adversely impact an agent's (worker, child) perception of the task, or of his own abilities. Incentives are then only weak reinforcers in the short run, and negative reinforcers in the long run. We also study the effects of empowerment, help and excuses on motivation, as well as situations of ego bashing reflecting a battle for dominance within a relationship.

Evidence on Performance Pay Mixed

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- Numerous studies in the 1990s showed that performance pay works (higher stock returns in U.S. and Japan, etc…).
- More recently, studies have shown that it is a dual-edged sword (short-term gains at long-term expense).
- Executives issue stock options when they are doing bad things like accounting fraud or too much investment risk.
- Studies of the financial industry have linked incentive compensation to highly speculative and sometimes outright illegal actions.
- Studies link incentive pay to reduced coordination and poor teamwork across different employee levels.

Corporate Culture #3: Culture in Theories of the Firm

The Theory of the Firm

A theory of the firm is a way to make sense of:

(i) why we have firms,
(ii) what goes on inside the firms, and
(iii) what are the boundaries of the firm.

For lawyers, can: (i) understand why problems may arise, (ii) potential solutions to problems, and (iii) the role laws vs. norms in implementing solutions.

This line of research has been on-going for almost 100 years!!

For firms to exist and thrive, the formal and informal systems combined must encourage new investment and protect existing ones.

The Relationship Between Laws and Nonlegally Enforceable Norms

ISLANDS OF CONSCIOUS POWER: LAW, NORMS, AND THE SELF-GOVERNING CORPORATION

EDWARD B. ROCK[†] & MICHAEL L. WACHTER[††]

This Article provides a theory of the relation between legal and nonlegally enforceable rules and standards in the corporation, and then uses that theory to analyze a variety of prominent features of corporate law. In the first Part, we draw on recent developments in the theory of the firm to identify key problems facing participants in the firm. In developing this approach, we combine the "property rights" strand in the theory of the firm with the transaction cost approach. From this perspective, the main issue is solving the related problems of coordinating activities, choosing the firm's assets, and developing appropriate incentives for specific investments. In Part II, we argue that the firm so understood will largely be governed through "norms," by which we mean "nonlegally enforceable rules and standards" ("NLERS"). Indeed, the raison d'être of firms is to replace legal/contractual governance of relations with NLERS. Using this framework, in Part III we analyze the duty of loyalty. In Part IV, we analyze the duty of care and the business judgment rule, along with a variety of other puzzling features of corporate law.

What reactions did you have to this article?

Did anything surprise you? Or change what you thought about corporate law and culture?

Summary of Today's Class

- Defining formal and informal institutions
- What is the relationship between formal and informal institutions?
  - Markets and morals
  - Shareholder governance and culture
  - Promotion and the Peter Principle
  - Intrinsic vs. extrinsic motivation and the role of incentive pay
  - Corporate law and nonlegally enforceable rules and standards

Reading

(Read intro) Graham, J., Grennan, J., Harvey, C., and Rajgopal, 2021, “Corporate Culture: Evidence from the Field”

Harvard Business Review. Jul-Aug. 2021, “Entrepreneurs and the Truth” by Kyle Jensen, Tom Byers, Laura Dunham, and Jon Fjeld

Washington Post, Jan. 27, 2002, “Enron's Culture Fed Its Demise” by Joe Stephens and Peter Behr