culturempresa
Culture e impresa - On-line journal - n. 4, November 2006
Fondazione Ansaldo Genova
Centro per la cultura d'impresa Milano
Supported by
International Council on Archives - Section Business and Labour

Managerial Irresponsibility and the New Business Model
by Luciano Gallino

A responsible business takes into account all the economical, social and environmental consequences that its activities may have on all stakeholders beyond its owners and shareholders: the list includes employees, territorial communities, investors, suppliers and small local businesses. The irresponsible business is the exact opposite: it considers the shareholders' interests, in particular those who own the major portion, as extremely important, while practically ignoring the interests of all others who are affected by the company's endeavors.. This latter behavior is not the result of the personal decisions of individual managers; rather it is imposed by a new business model, which has gained increasing acceptance since the early 1990s, and by major shareholders who now predominate among institutional investors
Over the last five years, notorious cases of irresponsible behavior of several managers in large financial companies have created a stir in Italy and worldwide. The banking scandals of the autumn-winter 2005 were widely publicized. At the end of 2005, several managers and major shareholders of Cirio, whose collapse began in early 2003, were charged with fraud. An even more serious instance is that of Parmalat, whose principal managers are currently on trial as a result of the class action suit that erupted at the end of the same year. In the United States, the trial and conviction of the top managers of Enron (declared bankrupt in 2001), WorldCom (declared bankrupt in 2002) and Adelphia Communications were particularly glaring examples.
All these top managers were accused of having deliberately falsified the companies' accounts, declaring inexistent profits and concealing losses for billions of euros or dollars. Their actions caused many institutional and individual investors to lose hundreds of billions in savings due to the resulting collapse in share value of these companies. Trust in the stock exchange and in proper corporate management suffered a dramatic blow. Consequently, it was deemed necessary, both in Italy and in the United States, to reinforce federal securities law and internal auditing controls. In the United States, this was accomplished with the law Sarbanes-Oxley, rapidly written and approved by the Congress in 2002, a few months after Enron's collapse. following these episodes, it is possible to conclude that the system of big companies is healthy and now contains the "antibodies" to fight rapidly and effectively against the eventual deviance of some of its parts. It is sufficient for the law to stimulate the activity of these antibodies.
However, some objections may be posed to such neat conclusions. The main one lies in focusing the attention on the behavior of individual managers. This attention seems appropriate at first sight but is actually very misleading. Too much attention from the media, as well as from political and judicial authorities on the financial aspect and on the irresponsible behavior of the single managers, will only detract from a necessary analysis of the structural causes that support this behavior in the first place. The critical point is not the episode of abnormal behavior of individuals; it is the aberrant definition of industrial strategies that, in the last fifteen years, have become accepted practice in company management .Thus managers are stimulated and even forced to implement

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them. I have discussed this theme extensively in my book *L'impresa irresponsabile* (The Irresponsible Business) (Einaudi 2005).
In order to explain the current behavior of the majority of managers, it is necessary to refer to the "new business model" that forms the basis of their training and that they are obliged to put into practice. According to this model, the primary mission of a company's management is value maximization for the shareholders. The application of this model has meant that all other stakeholders have far less importance in the decisional horizon of corporations. This shift in the conception of the company was theorized by many economists in the 1980s. Moreover, this change was facilitated by the arrival on the power scene of the institutional investors: pension funds (especially the British), investment funds and insurance companies.
In just ten years, the total of the financial instruments - stocks, obligations, derivatives, etc – managed by these institutions increased threefold in France, Germany, United Kingdom and United States, and by six in Italy, which had initially lower values. If we add to these the capital of similar investors in Canada, Japan, Holland and Swiss, the amount of the capital controlled and managed by institutional investors in 2000 topped 30 billion dollars, which, in that year, corresponded to the annual GDP of the entire world. In 2004, this sum was largely exceeded: the world's GDP was 41 billion dollars while the investors' titles (only in the OECD countries) were worth 45 billion dollars. It is important to notice that, in total, the institutional investors in the world are tens of thousands, but the amount of their capital seems to be in the hands of a few hundred of them.
It is these financial entities who create the "opinion" or "judgment" of the markets which are then reported in respected news sources. . Never before has such economical and financial power been concentrated among so few people.
Even though this is a form of vicarious property, or "property-by-proxy" (since managers administrate capital that doesn't actually belong to them), the institutional investors became the major owners of the big companies. Even if everyone of them doesn't own more than 2% of the capital of a single company, in many countries the institutional investors own altogether a part of the total share capital that varies from 40% in France to 75% in the UK. In Italy, this sum was estimated, for 2006, to be around 350-400 billion, which corresponds to about the half of the capitalization of the Italian stock market. This amount of stock capital is all centered in a small number of companies, generally the first 50 or 100 of every country according to their market value.
Institutional investors expect one result , and one only, from the companies in which they (that is, their managers) have invested: the maximization, in a short time, of the value of the stocks they own. Investments should generate a minimum yield of 15% of the capital invested, which rises to 20% in the case of private investment funds, the *private equity funds.* Managerial behavior has been deeply affected by such expectations: instead of the creation of a high added value, obtained through the production of goods and services, they are pushed to lift the short-term market value of the companies they manage. They are also encouraged to do this by their astronomical wages—400 to 500 times greater than a medium salary, which they manage to get from the company, disguised as salaries, stock options, "golden parachutes" and other benefits.
In order to meet similar requests, managers have globally reorganized the productive process controlled by their companies. First of all, they have unbundled the chain of creation of value through the mechanism of supply contracts and subcontracts all over the world. Most of the delocalization observed in the USA and in the EU was generated by the use of this networking mechanism. In this way, managers can quickly pinpoint any component in the production of value chain which appears to be under-performing , not in general but in comparison to the production of the competing companies. In this way, any "weak links" can then be replaced by other more efficient ones. Secondly, they have tried to approximate the organization of the ideal *virtual company*. This is a company in which the center for planning and control of its activities operates with a very limited number of employees—sometimes only a few hundred; on the other hand, these activities are managed by thousands of companies with tens, or even hundreds of thousands of

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employees. According to the model, these companies should be linked exclusively through a virtual network of commercial contracts that can be drawn up or revoked at any time , rather than through a physical net sustained by communication technologies. Actually, the new business model sees a company just as a contact net. The institutional or communitarian conception of business has been categorically put aside.
Enron, distributor of energy-related services, owed its success to its organization in the 1990s, when it became one of the first seven companies in the world in terms of its market value. The same organization, founded in order to create a stock value in the shortest time possible, was also the cause of its collapse at the beginning of the 21st century. Surely, this collapse was in part due to the irresponsible dishonesty of top managers, together with the factual contribution of the accountants, the financial analysts and the lawyers of the involved companies. However, our analysis hastens to underline the role of a fundamentally unhealthy organization, whose very model had been largely glorified by both media and many academics, that forced the managers in question to become irresponsible and dishonest.
There have been dozens of disasters similar to Enron's in the United States. In Europe, we are reminded of Vivendi in 2002 (debts for a total amount of 12 billion euros which came to light overnight) and Parmalat in 2003 (debenture debts not repayable for a total amount of 20 billion euros). Although every company has its own history, each of these financial collapses have similar causes. Lawrence E. Mitchell, an American jurist, summarizes them as follows: "The root of the problem is the structure of the joint-stock company itself. [This structure] encourages the managers to maximize stock prices, limiting their freedom of acting responsibly and morally. The result is an immoral behavior. [This behavior] has destructive effects especially on those groups that are external to the traditional company structure, all the people that don't belong to the group of shareholders and managers." (from *Corporate irresponsibility. America's newest export*, Yale 2001, p. 3).
In recent years, many international organizations such as the UN, the OECD, and the EU have taken several initiatives in order to increase "corporate social responsibility", referring implicitly or explicitly to the scandals of the 1990s and of the beginning of the 21st century. Nevertheless, these initiatives almost completely neglect the structural causes of the big companies' restriction of the decisional horizon and of their single-minded concentration on shareholders' interests. What is more, these basic structural defects were not considered in the wording of the legislative bill for the safeguarding of investors passed in 2005 by the Italian Parliament.
In fact, the topics summarized in this article lead me to conclude that only an amendment of corporate management structures, in terms of both the opportunity of enlarging the practices of economical and social responsibility for the company, and the need to involve the institutional investors could stimulate the adoption of business models oriented once again towards the creation of a long-term added value and not to the simple short-term stock value. On a final note, these models would extend their interest to all stakeholders.

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