

# Corporate governance reform: character-building structures

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*This paper argues that corporate governance reformers in Anglo-American jurisdictions should consider a different approach in their quest for better corporate governance. Traditionally, corporate governance reform has taken a structural approach, tightening the rules around the number of independent directors required on boards and committees and fine-tuning the definition of independence. However, such an approach has failed to achieve effective corporate governance. Moreover, this approach is informed by the arguably discredited assumption that individuals are rational self-interest utility maximizers. This conceptual paper questions why corporate governance scholars and regulators remain uncritical of this assumption and suggests an approach to reform inspired by a different view of human nature. Indeed, incorporating an actor-based approach to reform into existing structures may better achieve effective corporate governance while addressing an unjustified adherence to this flawed assumption.*

## Introduction

This paper argues that corporate governance reformers in Anglo-American jurisdictions should consider the character of directors in their quest for better corporate governance. Traditionally, corporate governance reform in countries such as the United States, the United Kingdom, Australia, and New Zealand has taken a structural approach. However, such an approach has failed to achieve effective corporate governance. Moreover, this approach is underpinned by agency theory and the arguably discredited assumption that individuals are rational self-interest utility maximizers. This conceptual paper argues that corporate governance scholars and regulators should reconsider their assumptions about human nature and modify their approach to governance accordingly.

Corporate governance regimes in most Anglo-American jurisdictions are based on agency theory, which assumes there will be a conflict of interest in the principal-agent relationship. In the event of governance failure, reformers have responded by tight-

ening monitoring and controlling mechanisms, mainly by increasing the influence of independent directors and fine-tuning the definition of independence. These structural reforms have been ineffective and in response, some scholars have argued for a greater emphasis to be placed on personal ethics and character. At the same time, there is a growing body of literature discrediting the *homo economicus* assumption underpinning agency theory and which to some extent has driven the structural approach to reform. The authors call on corporate governance reformers to consider basing reforms on a different view of human nature; assuming individuals are capable of habitually rising above their self-interest could permit reforms that inspire noble behavior and eliminate a box-ticking approach to governance. Actor-based reform may better achieve effective corporate governance while addressing underlying flawed assumptions.

The paper is organized as follows: firstly, it outlines the features of the Anglo-American approach to corporate governance and the influence of agency theory and its underlying assumption that the individual is a

rational self-interest utility maximizer. Next, there is a brief overview of scholarship critical of the rationality assumption. The following section outlines the general disillusionment with the structural reform in the field of corporate governance, which has been prompted by post-reform governance failures. This is followed by a summary of the literature calling on reformers to focus more on the personal ethics and character of directors and senior executives. The next section outlines literature supporting the relevance of Aristotelian virtue theory (AVT) for business and specifically for the achievement of good corporate governance. The final part of this paper suggests how actor-based reform (as opposed to structure-based) could be incorporated into the existing structures regulating corporate governance; possible areas for future research are outlined.

### Corporate governance and economics

The shareholder perspective of corporate governance developed out of agency theory and ultimately economics. This approach to corporate governance dominates Anglo-American jurisdictions (Letza *et al.* 2004, Roberts *et al.* 2005, Wieland 2005, Blackmore 2006, Barnett & Maniam 2008). Modern economics overall operates on the assumption of *homo economicus*, a model of the individual as a rational self-interest utility maximizer (Crockett 2005, Ghoshal 2005, Bragues 2008, Huehn 2008). This model assumes the decision maker always chooses the option that maximizes his or her utility, which is determined ultimately by the person's preferences. Advocates of this perspective commonly hold that 'the rational man always aims at a measurable utility correlative with "satisfaction" or "well-being" or some such, and always chooses among alternatives on this basis' (Rescher 1988: 107).

Agency theory assumes there will be a conflict of interest in a relationship of agency where one party (the principal) delegates work to another (the agent), who performs that work (Eisenhardt 1989). This negative attitude is the logical result of adopting an economic understanding of the individual. The main focus of agency theory is working out the most efficient contract to govern this relationship. In the corporate governance context, this means suggesting

governance mechanisms that limit the self-serving behavior of the agent (Eisenhardt 1989).

In the corporate governance context, the interests of managers may not converge with the interest of the owners; consequently, governance structures are needed to allow the owners (shareholders) to monitor and control the managers (Jensen & Meckling 1976, Shleifer & Vishny 1997). The owners need a board to look after their interests because it is threatened by self-interested management behavior. Self-interested managerial behavior becomes the main problem of corporate governance (Letza *et al.* 2008). Agency theory is a cornerstone of the corporate governance literature, policy, and practice in Anglo-American jurisdictions (Dalton *et al.* 1998, Daily *et al.* 2003, Lan & Heracleous 2010). It has shaped codes of good practice in corporate governance, director training, and the composition and procedures of corporate boards (Coffee 1999, Hansmann & Kraakman 2001, McCarthy & Puffer 2008).

Accordingly, agency theory has also shaped approaches to corporate governance reform, as the main emphasis becomes how to structure the board so it can better control management (McNulty *et al.* 2013). This is best illustrated by the codes in Anglo-American countries, which define best practice in the governance of companies (Grantham 2004). The main problem identified in these codes is the monitoring of senior management. This reflects the key assumption of agency theory that the interests of the owners and managers will diverge. The solution is to ensure the existence of a board able and willing to monitor management. This occurs by ensuring it is suitably independent, informed, and motivated. The board is to include independent directors making it quasi-external, have access to full information, and is motivated to act in the interests of the shareholders by linking their remuneration to the performance of the company (Grantham 2004).

Agency theory and its assumption of *homo economicus* have also influenced the place and nature of ethics in the art of corporate governance, reducing it to the ability to effectively balance reward and punishment. Collier & Roberts (2001) explain this as follows:

Within the agency view of governance there is in principle no ethics and hence no ethical problem.

Instead, we are confronted with an atomized self-seeking individual, who must be closely watched and can only be frightened or incentivized into taking account of the interests of others. The only ethical imperative at work here is a Friedmanesque dictum to pursue profit maximization. (p. 68)

The snapshot of typical corporate governance discourse from various jurisdictions in the next few paragraphs clearly illustrates how firmly this view of human nature is entrenched in the descriptions, explanations, and structures of corporate governance. The overall impression conveyed is that this view is undoubtedly true. This seems incredible given there is a substantial body of literature that calls this assumption about human nature into question.

The United States, United Kingdom, and Australia have a shareholder governance system based on the idea that the company's objective is to maximize shareholder wealth (Blackmore 2006, Barnett & Maniam 2008). The purpose of corporate governance standards is to protect the rights of shareholders. The shareholders elect a board of directors to oversee the management of the firm. Recent reforms of these systems have focused on enhancing corporate governance by promoting board independence (Linck *et al.* 2009). This has been done by requiring a majority of independent directors based on a more refined definition of 'independence'.

New Zealand also has a shareholder model. Corporate governance reforms enacted in 2004 tightened listing requirements and established a corporate governance code. Listed companies are subject to more stringent regulation including the inclusion of at least two independent board members, the appointment of an internal audit committee, and the insertion of a statement about corporate governance practices of the company including an explanation of why they have not complied with the code of best practice set out in the listing rules (Blackmore 2006).

There is no doubt that the notion of *homo economicus* and agency theory are central to corporate governance in Anglo-American jurisdictions. Managers are likely to pursue self-interest at the expense of shareholder welfare so appropriate governance must exist to curtail such behavior. Moreover, even the governors themselves need to be governed through the presence of independent

directors (Sison 2011). Should corporate governance scholars and regulators continue to rely on this assumption?

### Criticisms of the *homo economicus* assumption

A growing body of literature questions this economic understanding of human beings as rational self-interest utility maximizers. Williamson (1979) and Cochrane (2004), for example, have raised doubts about whether individuals can actually have complete information when making a decision. Human beings have physiological, neurological, and psychological limitations. Simon (2000) has shown how rationality is not unlimited but bounded. Perfectly rational decisions are not possible as the rationality of individuals is limited by the information they have, the cognitive limitations of their minds, and the finite amount of time they have to make decisions.

Others criticize the claim of moral neutrality (Hausman & McPherson 2006, Giovanola 2009) as indifference to the content of preferences implies an ethical subjectivism and relativism rather than neutrality. Perrow (1986) has claimed that the rational self-interest assumption is unable to explain the complexities of real-world organizations and contradicts the behavioral assumptions held by most organization theorists (Lubatkin 2005). Sen (1987) and Du Plessis (2003) argue that there is a plurality of motives that drive human beings. Daily *et al.* (2003) note the self-serving nature of managers and their opportunism is a simplistic view of human nature. Fontrodona & Sison (2006) point out that the self-interest model contains an internal inconsistency, as the exclusion of others' interests means there will be less information available and it will be more difficult to make the right decision. A recent book by behavioral economist Peter Ubel (2009) entitled *Free Market Madness* shows that in fact people are not that rational and often do not act in their own best interest. Instead, they are frequently irrational. With many examples, he illustrates how people struggle to make good choices and stick with them. He shows, for instance, how many of the growing health and financial problems in society are a result of people's own choices.

If *homo economicus* is such a flawed notion, why are corporate governance regulators and reformers so uncritical of their continued reliance on it? The next section provides evidence of the ineffectiveness of such reforms supplying further reasons to question this approach.

## Failed reforms

As mentioned above, corporate governance reform has focused on the structure of the board and associated committees as regulators, and researchers have accepted agency theory's assumption about human nature: that individuals are self-interest utility maximizers and cannot change. On the whole, there is an emphasis on compliance with rules surrounding board and committee structures, procedures, and codes of ethics, with the view to achieving board and auditor independence (Du Plessis 2003, Grantham 2004, Roberts *et al.* 2005, Bragues 2008). However, continued corporate governance failure since the 2002–2004 reforms has led some to question this approach (McNulty *et al.* 2013).

Siemens is a recent example of corporate governance failure despite being externally in appearance a model of 'post-reform' good corporate governance. Pursuant to the stipulations of the Sarbanes–Oxley Act, the New York Stock Exchange, the German Corporate Governance Code, and other requirements, Siemens developed a code of conduct that also expressed corporate policy. A corporate compliance officer reported regularly to the audit committee of the supervisory board. Managerial employees signed a pledge renewing their commitment to uphold these rules. Ethics counselors were widely available for employees who needed advice when confronted with a potential ethical conflict (Verschoor 2007). Yet Siemens recently engaged in large-scale bribery as a corporate strategy so as to obtain contracts fraudulently rather than through level-field competition. They have since agreed to pay billions of dollars in fees and fines (Verschoor 2007).

The 2007/2008 sub-prime mortgage scandals and resultant bank failures have also reignited the debate on the importance of corporate governance in general and of boards of directors in particular (Teh

2009). In 2008, Halifax Bank of Scotland failed and in 2009 the Royal Bank of Scotland announced the biggest loss in British corporate history (Smallman *et al.* 2010). Both failures were attributed to major failures in key aspects of corporate governance (Webster & Hosking 2009). It is important to note that these occurred under the auspices of a recently reformed corporate governance regime.

Since the 2004 reforms in New Zealand, there have been a significant number of companies exhibiting failures of corporate governance that have involved blatantly unethical and illegal behavior. Power (2010) notes,

Approximately 60 finance industry companies have collapsed or have arranged moratoria since 2006, which has put at risk around \$8.5 billion of investors' money. As a result, regulators have been investigating allegations of false and misleading statements and have laid charges against a number of directors of finance companies. (Para. 4)

Nineteen directors have been convicted in the High Court since 2010; seven of those are now in jail and a further nine are serving home detention or facing community service or fines. There are approximately 13 more directors still waiting for their day in court (Carruthers & Heine 2012).

These and other cases have been the catalyst for a growing body of literature that questions whether increasing the number of independent directors or having more sophisticated structures is effective in preventing corporate governance failure (Dalton *et al.* 1998, 2003, 2007, Ghoshal 2005, McNulty *et al.* 2013). Some researchers are dissatisfied because studies around structural issues such as board composition have been unable to provide conclusive evidence to confirm hypotheses about effective corporate governance, with some studies containing contradictory findings (Johnson *et al.* 1999, Hermalin & Weisbach 2003, Dalton & Dalton 2005, Roberts *et al.* 2005). While acknowledging these empirical studies have served the purpose of expanding and reinforcing a conceptual framework on which the traditional knowledge of corporate governance is built, researchers are wondering what else can be done to achieve effective corporate governance (Leblanc & Schwartz 2007, Erakovic & Overall 2010, Smallman *et al.* 2010, McNulty *et al.* 2013).



There is a growing movement favoring the investigation of actual board conduct, looking into the 'black box' of behavior rather than board structure and composition (Sonnenfeld 2004, Huse & Gabriellsson 2005, Leblanc & Gillies 2005, Erakovic & Overall 2010). Recent reviews of corporate governance literature have found that little is understood about the interior working processes of boards as very few studies have examined this phenomenon (Roberts *et al.* 2005). There is substantial discussion about what boards should be doing but not much is known about how they go about accomplishing these tasks (Zahra & Pearce 1989, Pettigrew 1992, Leblanc & Gillies 2003, Erakovic & Overall 2010). Although there are varying perspectives in this movement such as more emphasis on process, or behavior or praxis, they form a unified purpose: to develop a deeper understanding of the acts of governing rather than the outputs of governing (Smallman 2007).

There is an acknowledgment of ignorance on the part of researchers and regulators about how directors really behave and how to influence their behavior (Leblanc & Gillies 2003, Roberts *et al.* 2005, McNulty *et al.* 2013, Zattoni *et al.* 2013). There is a clear sense of uncertainty about how these individuals operate and how to help them do their job better. This also represents a willingness to actually think and dialogue about the behavior of directors rather than to *assume* they will act in a certain way. This acknowledgment in itself may represent a serious blow to the monopolistic sway enjoyed by the notion *homo economicus* and agency theory in the field of corporate governance.

### Directors' personal ethics

These recent corporate governance failures have galvanized some scholars to advocate increased attention be given to the personal ethics and character of directors rather than increasing regulation around board structure (Greenfield 2004, Gandossy & Sonnenfeld 2005, Schwartz *et al.* 2005, Wieland 2005, Robins 2006, Smallman 2007, Armstrong & Francis 2008a, Bragues 2008, Huehn 2008, Sison 2008, Ryan *et al.* 2010, Smallman *et al.* 2010). Several authors believe the problem lies with the per-

sonal ethics of the leaders. They place the blame for failed corporate governance specifically on unethical leaders and unethical leadership. Fassin (2005) has found that a common feature of recent financial scandals is unethical behavior by high-level managers themselves. Gini (2004) attributes governance failures to a lack of moral leadership because all leadership is value and vision laden. Knights & O'Leary (2006) concur in asserting that it is a failure of ethical leadership derived from the preoccupation with the self that drives individuals to seek wealth, fame, and success regardless of moral considerations. Arjoon (2006) is in agreement when he says 'the crisis of corporate abuses reflects a crisis of culture; a culture of governance to encourage ethical behaviour'.

Scholars acknowledge that law and codes of ethics are important but lack the moral firepower to encourage ethical behavior (Termes 1995, Torres 1997, Arjoon 2005, Gandossy & Sonnenfeld 2005, Bragues 2008). Arjoon (2005) claims reforms have failed because too much emphasis is placed on tightening compliance mechanisms in a bid to restrain and control the acting agents. He argues that increasing regulation does not motivate people to behave ethically because they do not perceive the link between compliance and their own happiness. In a similar line, scholars warn that corporate governance failure is not necessarily fixed by legal reform; it depends on the underlying problem that often has to do with the morality of people rather than gaps in the law (Greenfield 2004). Legal reforms are ineffectual without attention to ethical obligations (Schwartz *et al.* 2005). Longstaff (1996) cautions that an over-emphasis on legal compliance could be at the expense of ethical reflection and the taking of personal responsibility for decisions.

This is why Gandossy & Sonnenfeld (2005) argue that reformers need to refocus; they believe

it is time to shift the debate from rules and procedure, to focus now on what we really know about people and their character. Therefore, the language of the law and the guidelines of accounting matter but they are not the entire equation. In short, we argue that only so much deterrence is possible through even the most precise laws and expert systems of compliance. Ultimately, execution is guided by human judgment. . . . The culture of the

board must recognize that the firm's interests are not necessarily the same as those of management. (p. 242)

Kleining (1999) asserts that law is primarily concerned with conduct and ethics with intention, reason, motive, and most importantly character; ethics is concerned with what we are, not what we do. Torres (1997) claims that without the help of virtue, ethical compliance is indistinguishable from legal compliance.

There are some corporate governance scholars who suggest that the current approach to reform underestimates the potential nobility of the human being. Wieland (2005) believes that we should not assume that human beings will always act opportunistically; human beings can be 'enabled' to act well. He is of the opinion that Anglo-American jurisdictions over-emphasize management control and the defensive aspects of monitoring and neglect to foster individual integrity. He states 'corporate governance cannot be interpreted solely as constraint of behaviour (e.g. as limitation of exposure to risk). It should also be understood as enabler of behaviour (e.g. in so-called grey zones) for managing transactions with integrity' (p. 77). Arjoon believes an emphasis on character and virtue will help individuals make the link between happiness and ethical behavior. Such an approach galvanizes the natural goals contained within human nature (Grasso *et al.* 1995).

Kimber & Lipton (2005) in surveying the corporate governance regimes of the Asia-Pacific conclude, similar to the above, that poor ethics has caused corporate governance failures. They found two diverging belief systems underpinning attitudes toward directors and senior executives: either directors or senior executives were driven by self-interest and require stringent regulation to constrain their natural behavior, or they have an innate capacity to be good stewards and virtuous leaders and their personal sense of high moral standards underpins good ethical behavior in business. They end their paper calling on those in senior roles to remember that sustainability rests ultimately on their personal capacity to maintain high standards and principles and foster ethical processes.

A number of authors specifically identify moral character as pivotal to implementing codes and rules

in the corporate governance context (Arjoon 2005, Gandossy & Sonnenfeld 2005, Armstrong & Francis 2008b, Bragues 2008). Several authors argue that directors and senior management need to be ethical role models for the creation and maintenance of an ethical organizational culture (Weaver *et al.* 1999, Schroeder 2002, Schwartz *et al.* 2005, Schwartz 2009).

It should be noted that the above views represent a line of thinking that is incompatible with the *homo economicus* assumption. It assumes that people themselves can be 'reformed', that they can internalize the idea that money is not the be all and end all of life, but that there are moral principles to which the pursuit of wealth must sometimes be sacrificed (Bragues 2008). The assumption of *homo economicus* precludes altruism or selflessness, or a consideration of the 'good' and the 'other' (West 2009).

It is suggested that AVT may provide the anthropological foundation for the yearnings reflected in the above literature. AVT is primarily concerned with the development of moral character and acknowledges the complexity of the human person: humans can be rational and irrational, self-interested, and others-focused. This paper argues that corporate governance reformers should give credence to this complexity and give more attention to the type of actors who govern. It argues that a focus on the character of directors and a consequential broader understanding of corporate governance could add value to the existing structures and achieve effective corporate governance.

## Character in business and corporate governance

The focus on character and virtue is not limited to the field of corporate governance, and its relevance for business is supported by the business literature in general. There is now a substantial amount of literature discussing the importance, relevance, and benefits of AVT for business. There are a significant number of articles in the areas of: virtuous organizational culture (Whetstone 2003, Moore 2005, Arjoon 2008); virtue and ethical decision making (Whetstone 2001, Mele 2005, Bhuyan 2007, Bastons

2008); the virtuous organization (Collier 1995, Moore 2005); and virtuous leadership, the focus of this investigation (Mintz 1996, Duska & DesJardins 2001, Whetstone 2001, Solomon 2003, McGhee & Grant 2009). Much of the literature acknowledges the pre-eminence of virtuous leadership and its potential to foster an ethical culture. Some research points to virtuous leadership as a possible antidote to unethical behavior in organizations (Arjoon 2000, 2008, Hartman 2001, Sison 2003, Mele 2005, Bragues 2006, Havarde 2007, Flynn 2008, Grant & McGhee 2011).

A broader notion of character is considered to be an essential element of good leadership in the general leadership literature (Ciulla 2004, Kouzes & Posner 2005, Knights & O'Leary 2006, Sarros *et al.* 2006). The early Greek philosophers saw character as central to a life of moral conduct (Sherman 1989). Bennis (1993) believes that character is the most important quality of a leader, consistent with more recent research by Calabrese & Roberts (2002). Despite the acknowledged importance of character to effective leadership behavior, very little is known empirically about the character of business leaders, which is an area for future research (Sarros *et al.* 2006). Corporate governance regimes already recognize that directors are responsible for developing an ethical organizational culture. For instance, Principle One states that directors should *observe* and foster high ethical standards; and in the accompanying commentary, the Securities Commission declares that governance structures will be ineffective if directors are not committed to high ethical standards. This leadership literature further supports the authors' argument that incorporating a character-based approach to reform could greatly contribute to the achievement of best practice corporate governance.

Sison (2008) is critical of the current approach to governance that seems to forget that the outcome of good governance cannot be separated from the internal or personal dispositions of the agent. He claims that most approaches to governance treat governance as production – to produce codes, structures, and processes – instead of focusing on the acts of governance and thus the governors themselves, what these acts reveal about the governor, and how they affect the character of the governor. Sison (2011) has suggested that corporate governance should be

viewed as 'praxis' in the Aristotelian sense. Corporate governance is an instance of action rather than production, so good corporate governance is measured by how it affects the character of the governor. He argues that directors of good character in the Aristotelian sense are a possible avenue for achieving ethical corporate governance. This is because of its potential to develop leader-role models who understand ethics to be integral to their ordinary actions and a meaningful life; their virtuous character itself provides guidance when judging how to act in concrete situations. Sison's view supports the growing call by corporate governance reformers to focus attention on the personal ethics of governors; personal ethics influence the quality of governance because of the link between character, judgment, and action as explained by AVT.

Smallman (2007) also complains that the focus of the recent reforms around board structure and procedure has little to do with governance as praxis and particularly *eupraxia* (good action). He argues that reformers need to find out more about the directors themselves:

Their knowledge, experience and skills: we need more evidence about acts of governing rather than the output from such acts if we are to develop a deeper understanding of governance; we need to understand directors as well as the artefacts they produce. (p. 243)

Sison (2008) emphasizes the benefits of prudence or *phronesis*, which develops with virtue. If a moral agent neglects Aristotelian *phronesis* (which includes excellences of character or moral virtue), he or she cannot mediate adequately between moral rules or principles and moral problems (Klein 1998). A prudent governor would be able to know what a particular virtue such as honesty requires in a specific situation and so be able to better design and implement systems and policies, which are virtue centered. Such a person will be able to discern among a variety of strategies the one that best achieves the goals of a virtuous organization, as practical wisdom has the task of guiding action through the thickets of particularity (Bragues 2008).

In his last publication, Sumantra Ghoshal (2005) asked the following question: 'What would happen if we acknowledged this complexity of human nature

in our theories, this combination of good and evil, instead of focussing on Friedman's negative problem?' (p. 85).

This paper has discussed how developments in the field of corporate governance have highlighted the inadequacy of the *homo economicus* assumption and revealed a willingness to explore alternative explanations of how the human being may operate. A substantial body of literature is searching for a vision of the human being that is more positive; a vision that allows for an intrinsic moral dimension that contains the desire and the potential to act disinterestedly. This willingness to focus on improving the character of leaders represents a readiness to question and modify the assumptions about human nature in the field of corporate governance.

Existing corporate governance regimes already give importance to ethics by requiring the development and compliance with codes of conduct. However, a focus only on codes of ethics can tend to emphasize control rather than encourage and support nobler behavior. Such a framework is bereft of moral motivation as it fails to supply the link between behaving well and one's personal happiness. It also neglects the role of prudence in the application of an abstract principle to a concrete situation (Mele 2005). Choices actually change the maker of those choices for better or worse that in turn affect their future capacity for judging and making choices (Torres 1997). In other words, if one excludes the role of virtue in ethical choices, ethics becomes more akin to law, bereft of moral motivation. As there is no link between ethical behavior and happiness or becoming a better person, ethical behavior is more likely to be driven by the fear of getting caught (Arjoon 2005).

### Practical implications for reform

Directing reforms toward the actors themselves is challenging. Obviously, regulators cannot force people to change, but they can create and reinforce a certain expectation by modifying law and the recommendations contained in best practice codes of listing rules and any other corporate governance codes directed to both issuers and non-issuers. The aim of reform should be to instill a belief in business

and society that a good character is a pre-requisite for directors being able to observe and foster high ethical standards and for business itself to contribute to human flourishing. By '*eudaimonia*' or flourishing, Aristotle meant a life in which our human capabilities are put to their best use (Flynn 2008). This is a life lived *kat' areten*, that is, a life lived in accordance with virtue; it is ultimately one's character that determines happiness, not the bottom line (Solomon 2004). 'For Aristotle, a fulfilled, happy or successful life consists finally in living entirely virtuously, together with moderate good fortune, throughout an entire lifetime' (Hutchinson 1995: 204).

*Eudaimonia* can only be achieved in communion with others. Business is a necessary part of this process by providing such things as meaningful work, technological advancements, and worthwhile goods and services. At the same time, individuals in business have to think of themselves as members of larger communities (not isolated self-interested individuals) – the family, the neighborhood, society – and strive to excel, to bring out what is best in these communities as well as in business. Organizations, like individuals, are part and parcel of the communities that created them, and the responsibilities they bear are not the products of implicit contracts but intrinsic to their very existence as social entities (Solomon 2004). In this world view, the goal of self-interest is replaced with human flourishing, which does not exclude the pursuit of private ends; it only excludes the pursuit of private ends to the detriment of human flourishing (Argandona 1998). Business should firstly serve society's demands and human flourishing and secondly be rewarded for doing so. Without such a mission, a company is just a bunch of people organized to make money while making up something to do. According to AVT, meaningful human activity is that which intends the good rather than stumbling over it on the way to merely competitive or selfish goals (Solomon 2004). This is why it is important that the governors are persons of good character.

The ultimate goal of reform would be to disseminate throughout society that the director of good character is the only type of director worth having and good corporate governance is that which contributes to human flourishing. Good character supplies the moral motivation to act ethically and



contributes to the development of a capacity to judge wisely in the particular situation, supplying the wherewithal to be ethical role models and ethics stewards of organizations, which contribute to human flourishing.

The New Zealand corporate governance regime, for example, makes no reference to the personal qualities of directors or potential directors. This regime consists of Listing Rules, various statutes such as the Companies Act 1993 and the Securities Act 1978 and the Corporate Governance Code established by the Securities Commission for both issuers and non-issuers. The Stock Exchange Listing Rules contain rules that specify a minimum number of independent directors, discusses the establishment of an audit committee, and sets out technical definitions of independence. It also includes a Corporate Governance Best Practice Code in appendix 16 against which issuers must report to what extent its processes materially differ. This code recommends the separation of the chief executive officer (CEO) and chairman, the formulation of a code of ethics, the establishment of nominations and remunerations committees, and that directors undertake appropriate training. In the interpretation section of the Listing Rules, the definition of 'director' simply explains to whom the rules apply where the issuer is a Managed Fund. Section 126 of the Companies Act entitled 'Meaning of Director' explains a director is a person occupying the position of director; subsequent sections set out their duties. A similar definition is contained in the Securities Act 1978. Section 151 of the Companies Act sets out who is disqualified from being a director. The Code of Corporate Governance Practice established by the Securities Commission recommends nine principles of corporate governance. This is the only place in the New Zealand corporate governance regime where there is an explicit reference to directors' personal ethics. As mentioned above, Principle One states that directors must *observe* and foster high ethical standards throughout the organization. In the first sentence of the following commentary is written: 'Unless directors and boards are committed to high ethical standards and behaviours, any governance structures they have put in place will not be effective' (p. 8).

The authors suggest that the abovementioned view be explicitly incorporated in the NZX Listing Rules'

corporate governance code, in the code of ethics section. Furthermore, this understanding could be included implicitly in the various aspects of the regime. 'Director' could be defined in the Company's Act and NZX Listing Rules as a person of proven good character or of high integrity. Or only persons of proven good character can be appointed as chairman, CEO, and head of the audit, nominations, and remuneration committees. This is perfectly compatible with the existing corporate governance regime. In all jurisdictions, directors are burdened with the responsibility of overseeing the ethics of the organization. Reform could reinforce this preference for character-based leadership by setting out positive qualifications rather than just the negative disqualifications.

The regime makes little mention of the purpose of corporate governance. The only explicit reference is found in section 131 of the Companies Act, which limits governance to promoting the best interests of the company, a phrase that in practice amounts to maximizing shareholder value. Perhaps this section could be amended to reflect matters contained in section 172 of the Companies Act in the United Kingdom. A director must take into account the following matters when promoting the success of the company: (1) the likely consequences of any decision in the long term; (2) the interests of the company's employees; (3) the need to foster the company's business relationships with suppliers, customers, and others; (4) the impact of the company's operations on the community and the environment; (5) the desirability of the company maintaining a reputation for high standards of business conduct; and (6) the need to act fairly as between members of the company. Points 1, 2, and 4 reflect a broader view of the purpose of corporate governance and could better accommodate an Aristotelian interpretation of the aims of business and corporate governance.

Another area of reform is the area of director training. Both corporate governance codes include recommendations about providing training to directors. Character development could be incorporated into governance education. By the time someone becomes a director, his or her character is very much developed but the notion of virtue/vice in AVT is not a habit set in concrete. People can lose or acquire as easily as they have gained or lost virtues. There is

nothing preventing a 50-year-old from improving his or her character. Moreover, these days younger people are being encouraged and are seeking to be directors. A section on character could be included in appraisal mechanisms.

The New Zealand Institute of Directors, for example, offers a wide range of courses catering for directors according to their roles and experience (Institute of Directors New Zealand Inc. 2013). There are no courses that deal with character development. The courses seem to emphasize technical competency. The first level provides the essential skills to establish a base level of governance knowledge; the second level assumes a basic knowledge of governance and focuses on the application of directorship skills; the third level offers more experienced directors a forum to update their knowledge through discussion and debate with peers.

Such a course could be developed based on the content and approach to character education used by some of the more innovative international business schools such as IESE Business School (IESE Business School n.d.). IESE offers a global executive Master of Business Administration that places a lot of importance on the development of character. It aims to inspire and support both the professional and *personal* growth of the participants. Courses specifically focus on personal development such as 'Managing Oneself' and 'Leadership: Talent & Character'. The main objective of 'Managing Oneself' is to help participants develop self-knowledge and, as a consequence, overcome negative behavioral aspects and enhance positive traits (IESE Business School n.d.). Values and humanity are deeply integrated into the subjects and the program. However, these are not purely theoretical sessions as the approach to learning is more personalized. In small classes, concepts are combined with case studies and discussion, drawing from and linking back to the experience of the participants. This would be the logical place to explore the role of business in society and the more human approach to corporate governance discussed above.

It is noteworthy that in the field of ethics education, training programs based on character or virtue have been found to be more effective in actually *changing* participants' attitudes and behavior. Schwartz (2009), for example, evaluated a training

program based on Aristotelian virtue. After observing and interviewing senior executives participating in the ethics training program, he concludes that an Aristotelian approach to ethics training may be the best way to establish a sustainable ethical corporate culture. He also cites the work of Sekerka (2009) who, after reviewing ethics training best practices across eight organizations, concludes that: 'an emphasis on ethical competency development [i.e. a virtue-based ethics approach] will help employees exercise ethics as an active "practice" rather than seeing ethics as a form of forced compliance' (p. 94).

Future research should explore whether directors' personal ethics really influence how they govern and if AVT could contribute to how they practice ethics in corporate governance. A qualitative study would best capture director's lived experience of ethics to be able to explore how directors understand the role of ethics in corporate governance and whether their understandings resonate with any philosophical ethical theories such as AVT. Researchers could also conduct a global comparison of any existing character-based education courses offered for managers and directors, analyzing their content, approach, and effectiveness.

## Conclusion

This conceptual paper has argued that corporate governance reformers should incorporate a more personal dimension into corporate governance reform: to focus on reconstructing the social constructs of director and corporate governance. The governance approach in Anglo-American jurisdictions needs to adopt a positive view of human nature and a more holistic vision of society that a person can rise above self-interest and society is a community of interdependent persons working toward a common goal. Regulators must acknowledge that agency theory and the assumption of *homo economicus*, which has influenced their approach to reform up to now, has been heavily criticized. Some scholars have recognized the need to take an approach to governance that focuses more on enabling rather than controlling, on judgment and motivation rather than compliance, on contributing to human flourishing rather than maximizing share-

holder value. In the past, reformers have concentrated on increasing the board's capacity to monitor and control management through increasing board independence by manipulating board composition and fine-tuning the notion of director independence. Giving more attention to fostering directors of good character and a more inclusive understanding of corporate governance may enhance the effectiveness of existing corporate governance structures. Reformers should aim for a change of culture by embedding the importance of good character and a society-focused outlook into law, codes, and training courses, thereby registering their awareness that the individuals they are regulating are capable of rising above opportunism to achieve human flourishing.

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