***Teaching Note:* Case 3 – American International Group and the Bonus Fiasco**

# **Case Objectives**

1. To help students understand how the ethical orientation of leadership is a key factor in promoting ethical behavior.
2. To help students understand the role of strategic control mechanisms in aligning the interests of all organizational stakeholders.
3. To encourage discussion of the effectiveness of external regulations in dealing with issues of ethical corporate behavior.

See the table below to determine where to use this case:

NOTE: There are both PRIMARY and Secondary chapters that can be used for this case. The Teaching Note gives guidance for the PRIMARY use chapters, and provides suggestions if the instructor wants to use the case to illustrate concepts from the Secondary chapters.

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| **PRIMARY Chapter Use** | **Key Concepts** | **Additional Readings or Exercises** |
| 11: Strategic Leadership | Leadership; ethical orientation; integrity-based vs. compliance-based ethics | **NOTE** – see news stories, web links and **video** links embedded in this section. |
| 9: Strategic Control & Governance | Strategic control; traditional vs. contemporary control system; informational vs. behavioral control; corporate governance mechanisms; stakeholder management; external governance control mechanisms | **NOTE** – see news stories, web links and **video** links embedded in this section. |
| **SECONDARY Chapter Use** |  |  |
| 4: Intellectual Assets | Intellectual, human and social capital |  |
| 10: Organizational Design | Organizational structure |  |

# **Case Synopsis**

In 2008 the financial crisis began with sharply declining housing prices, leading to an escalation of a broader economic crisis involving banks and investment banking firms. This impacted both regulated and unregulated industries, including insurance companies.

AIG was an insurance company trading in an unregulated industry using Credit Default Swaps (CDS). A CDS is insurance on a mortgage-backed security, providing the holders of this security coverage in the event the value of the security goes down. When the housing market tumbled, AIG had to pay out on CDS since the value of mortgaged houses fell below the face value on the original mortgages. To keep AIG from going bankrupt, the U.S. government provided an $85 billion loan to cover initial CDS loses. AIG received a second loan of $37.8 billion later in 2008. After receiving this government bailout money, AIG then made a series of publicly embarrassing mistakes by treating employees to a lavish retreat in California and an extravagant trip to England. In March 2009 there was a public outcry when it was revealed that AIG had paid $218 million in bonuses to its financial services division, the very division that was responsible for issuing the CDS. While the media revisited the poorly managed Federal monies, several State's Attorneys began to mobilize to protect its citizens, and the U.S. House of Representatives moved to limit the bonuses through a 90% tax on the distributions. Edward M. Liddy, AIG's chief executive, caved under the questioning of the House, suggesting that the tax was appropriate.

Jake DeSantis, an AIG financial services executive vice president, provided a different perspective. Only a small portion of financial services managers had worked with the dysfunctional CDS. In cooperation with the spirit of the bailout, many managers in the division had agreed to work for a salary of $1 a year. Several continued to work 10-14 hours a day under these conditions based on a promise from AIG to compensate them through the distribution of bonuses. The CDS losses also resulted in the elimination of many managers’ life savings. Many of them were also shareholders of AIG stock. Under a 90% taxation provision, this left most managers without an income or other means of financial support. Was the government right to impose controls on how AIG rewarded its employees? Did AIG leadership act ethically in this situation?

# **Teaching Plan**

This case was written to provide a forum for discussing the issues of ethical leadership, strategic control mechanisms, external governance, and stakeholder responsibility. What do leaders have to do in order to nurture a culture dedicated to excellence and ethical behavior? How did the decisions made by leadership affect the firm’s functioning and its relationships with multiple stakeholders who relied on the organization? However, fundamental to the case is the examination of strategic controls, both internal and external, and to what extent these controls can be effective in inspiring and maintaining an ethical orientation toward the design and use of appropriate reward mechanisms in public companies.

Regarding issues of leadership, ethics, and strategic control, the instructor may want to contrast the AIG situation with the example of Enron’s collapse in 2001. The instructor can provide historical context by reminding students about the ethical issues that surrounded Enron (information about this case is available from several sources, including <http://www.nytimes.com/2006/05/26/business/businessspecial3/26verdict.html>). Students can be asked if they think Enron’s lessons about corporate governance, a cautionary tale from the 1990s, were learned by the U.S. corporate community. Based on AIG’s decisions, it appears not…

NOTE: this AIG case can also be used in a course in organizational behavior to illustrate organizational decision-making, motivation theory and rewards, and individual behavior under stress. It could also be used in a discussion of overall financial controls in the context of a larger economy, in which case it might be accompanied by a full-length documentary film such as *Inside Job*, (see <http://www.sonyclassics.com/insidejob/> ) or *Too Big To Fail* (see <http://www.hbo.com/movies/too-big-to-fail/index.html> ).

# **Summary of Discussion Questions**

Here is a list of the suggested discussion questions. You can decide which questions to assign, and also which additional readings or exercises to include to augment each discussion. Refer back to the Case Objectives Table to identify any *additional readings and/or exercises* so you can integrate them into your lesson plan if you wish.

1. Ethics comes from the top of the organization. How did AIG’s leadership handle the situation?
2. What controls did AIG have in place, and how did those controls affect its corporate behavior?
3. Provide a stakeholder analysis of those affected by the bonus issue. What alternatives are present to prevent or lessen these sorts of events? How effective are external regulations in encouraging ethical behavior?
4. OPTIONAL DISCUSSION QUESTION: Is there any way to reconcile the reasoning behind the bonuses and the government response? Consider if you had complete control over the administration of the bonuses back in March 2009. Draft a plan integrating the best points of the different perspectives.

# **Discussion Questions and Responses**

1. ***Ethics comes from the top of the organization. How did AIG’s leadership handle the situation?***

**Referencing Chapter 11: Strategic Leadership: Creating a Learning Organization and an Ethical Organization**

The concept of *leadership* involves the process of transforming organizations from what they are to what the leader would have them become. This definition implies dissatisfaction with the status quo, a vision of what should be, and process for bringing about change. Leaders are change agents whose success is measured by how effectively they formulate and implement a strategic vision and mission.

See Chapter 11, Exhibit 11.1. This involves:

* Setting a direction
* Designing the organization
* Nurturing a culture dedicated to excellence and ethical behavior

The interdependent nature of these three activities is self-evident. Consider an organization with a great mission and a superb organizational structure, but a culture that implicitly encourages shirking and unethical behavior. Often, failure of today’s organizations can be attributed to a lack of equal consideration of these three activities. The imagery of the three-legged stool is instructive: it will collapse if one leg is missing or broken.

Leaders need to *set the direction for the organization* by continually scanning the environment to develop knowledge of all stakeholders, and knowledge of salient environmental trends and events. Then leaders must integrate that knowledge into a vision of what the organization could become. Leaders require the capacity to solve increasingly complex problems, and must be proactive in their approach so they can develop viable strategic options.

Although not in the case, AIG’s leadership prior to the appointment of Edward Liddy had worked aggressively to grow the firm into a global leader. The goals were international recognition and profit. The decision to enter into the credit default swap (CDS) business was proactive at the time, because of the profit potential.

Leaders are responsible for *designing the organization*: a strategic leadership activity of building structures, teams, systems, and organizational processes that facilitate the implementation of the leader’s vision and strategies. Leaders have an important role in creating systems and structures to achieve desired ends.

Given previous leadership’s goals, the creation of specific divisions at AIG to handle things like financial services, and equity and commodity trading, in addition to traditional insurance, made sense – all were profitable at one time. However, these divisions appeared to have little to do with one another, and might have been unrelated enough to prompt the sale of the commodity index business to UBS. These unrelated businesses might have added confusion to employees’ understanding of the direction of the firm.

Difficulties in implementing the leader’s vision and strategies include a lack of understanding of responsibility and accountability among managers, reward systems that do not motivate individuals and groups toward desired organizational goals, inadequate or inappropriate budgeting and control systems, and insufficient mechanisms to coordinate and integrate activities across the organization.

Since AIG had close ties to investment banking, it made sense to implement reward systems that were standard in that business – stock options, bonuses, perks such as resort retreats and other outings. Given the growing resentment over the years at the perception of “greedy Wall Street” businesses, in hindsight it seems obvious that AIG leadership should have understood the difficulties something like the bonus reward system might create – not only in the behavior of AIG executives (greed is good), but in the public perception of AIG’s intent. (Here’s where a reference to Gordon Gekko might provoke a chuckle from older students – see <http://www.youtube.com/watch?v=-TlIt6yJVHU&NR=1> for the trailer from the 1987 film *Wall Street*.) Therefore the leaders, Liddy included, lacked understanding of the responsibility they had to the public, to stakeholders at large.

Leaders, especially those who have responsibility for some degree of public trust, must also maintain at least the outward appearance of an ethical business culture. See the definition of *organizational ethics* toward the end of the chapter: organizational ethics arethe values, attitudes, and behavioral patterns that define an organization’s operating culture and that determine what an organization holds as acceptable behavior.

The ethical organization is characterized by a conception of ethical values and integrity as a driving force of the enterprise. Ethical values shape the search for opportunities, the design of organizational systems, and the decision-making process used by individuals and groups. These values provide a common frame of reference that serves as a unifying force across different functions, lines of business, and employee groups.

Organizational ethics helps to define what a company is and what it stands for. The *ethical orientation* of the leader is a key factor in promoting ethical behavior, promoting an ethical orientation. A strong ethical orientation can have a positive effect on the organization’s commitment and motivation to excel. *Ethical orientation* involves the practices that firms use to promote an ethical business culture. Leaders who exhibit high ethical standards become role models for others and raise an organization’s overall level of ethical behavior. The ethical organization is characterized by a conception of ethical values and integrity as a driving force of the enterprise. Ethical values shape the search for opportunities, the design of organizational systems, and the decision-making process used by individuals and groups. They provide a common frame of reference that serves as a unifying force across different functions, lines of business, and employee groups. Organizational ethics help to define what a company is and what it stands for. The advantages of a strong ethical orientation can have a positive effect on employee commitment and motivation to excel. This is particularly important in today’s knowledge-intensive organizations, where human capital is critical in creating value and competitive advantages.

A key point in the AIG case is where AIG’s executive vice-president Jake DeSantis points to Liddy’s promise that the company would “live up to its commitment” to honor the retention contracts, believing the contracts to be “both ethical and useful”. Also DeSantis believed management’s initial decision to honor the contracts was “both ethical and financially astute”. It seemed that DeSantis had assumed AIG management had a strong ethical orientation, and that that ethical orientation had encouraged DeSantis and others to continue their commitment to the organization in spite of other job offers. DeSantis and others thought they understood what the company was, and what it stood for. When it appeared that Liddy had abandoned them in front of Congress, the employees felt betrayed.

There cannot be high-integrity organizations without high-integrity individuals. However, individual integrity is rarely self-sustaining. Even good people can lose their bearings when faced with pressures, temptations, and heightened performance expectations.

Organizational integrity rests on a concept of purpose, responsibility, and ideals for an organization as a whole. An important responsibility of leadership is to create this ethical framework and develop the organizational capabilities to make it operational. There are two approaches that can be used to create this ethical framework: the *compliance-based* and the *integrity-based* approach. See Exhibit 11.5. Faced with the prospect of litigation, several organizations reactively implement *compliance-based ethics programs***.** Such programs are typically designed by a corporate counsel with the goal of preventing, detecting, and punishing legal violations.

But being ethical is much more than being legal, and an integrity-based approach addresses the issue of ethics in a more comprehensive manner.

*Integrity-based ethics programs*combine a concern for law with an emphasis on managerial responsibility for ethical behavior, including (1) enabling responsible conduct; (2) examining the organization’s and members’ core guiding values, thoughts, and actions; and (3) educating others about the responsibilities and aspirations that constitute an organization’s ethical compass.

As the textbook says, seldom does the character flaw of a lone actor completely explain corporate misconduct. Leaders play a key role in changing, developing, and sustaining an organization’s culture. An excellent and ethical organizational culture is an organizational culture focused on core competencies and high ethical standards. Organizational culture can be an effective means of organizational control.

In *nurturing a culture dedicated to excellence and ethical behavior*, managers and top executives must accept personal responsibility for developing and strengthening ethical behavior; consistently demonstrate that such behavior is central to the vision and mission; develop and reinforce role models, corporate credos, codes of conduct, reward and evaluation systems, policies and procedures that support the *ethical orientation*. Doing this requires leaders to overcome barriers to change and effectively use their power.

It’s probably unfortunate that Edward Liddy was the target of most of the outrage from all stakeholders. Although not in the case, Liddy had only been CEO for less than six months when the news about the bonus situation broke. Reports are that Liddy was asked by then Treasury Secretary Hank Paulson to step in when AIG’s failure became imminent. There’s no way of telling what Liddy might have done had he been in control in the years prior to AIG’s failure.

Jake DeSantis, from what we know from his letter, appears also to want to be a role model for integrity. We don’t know his exact motivation for writing this public letter, but from what he says, he and his people did try to nurture a culture of excellence.

Certainly Liddy did appear to try to enable responsible conduct – the fact that he even took the job indicates that he was willing to take managerial responsibility. He was also willing to examine the organization’s actions, and to take what opportunity he had to educate all stakeholders about the issues involved. He made the tough decision to go ahead with the bonuses, presumably because he felt this was the ethical thing to do. Hopefully the next CEO of AIG would be able to institute an integrity-based ethics program, one based on transparency.

**NOTE – ADDITIONAL READING AND VIDEO NEWS REPORTS:**

Although the case focuses on then current AIG CEO Edward Liddy, the story of AIG ex-CEO Maurice R. (Hank) Greenberg might be the most interesting one. Here’s an article from September 2008 just after AIG collapsed, which gives Greenberg’s history and provides some insight into the type of leadership he exhibited as leader of the company for 27 years:

<http://abcnews.go.com/Business/Story?id=5826500&page=1>

Also from March 2009 here are **videos** of then CEO Edward Liddy giving testimony before Congress on the bonus situation:

<http://www.youtube.com/watch?v=VR4z6O7Entg> (Liddy being questioned by Congressman Elijah Cummings about the role of bonuses)

<http://www.youtube.com/watch?v=3I80qfMdraM&feature=related> (Liddy explaining how the Federal Reserve was aware of the bonus situation, but Congress was not directly in the communication loop.)

Liddy received the brunt of the outrage, but he had only been CEO for less than six months when the new about the bonus situation broke. Reports are that Liddy was asked by then Treasury Secretary Hank Paulson to step in when AIG’s failure became imminent. On May 21, 2009, Liddy announced that he would step down from his post at AIG once successors had been found – successor**s** because Liddy had recommended that the Board separate the jobs of CEO and Chairman of the Board:

<http://abcnews.go.com/Business/Economy/Story?id=7648994&page=1>

Based on the above, was Liddy the correct target for all the anger? Should he have done or said something different to protect either himself or AIG during the bonus story coverage?

Here is a website with overview links to the overall AIG rescue situation. Contained here are .pdf documents with timelines and testimony from various parties:

<http://www.businessinsurance.com/article/99999999/PAGES/1156>

Of particular interest is the succession of CEOs after Maurice (Hank) Greenberg attained the CEO position in 1987. In 1997 Hank’s son Evan Greenberg was promoted to COO. Evan resigned in 2000, and his father remained CEO, but Hank was succeeded by Martin Sullivan in 2005 after an accounting scandal. Sullivan was replaced himself in 2008 by Robert Willumstad. Willumstad was replaced by Edward Liddy several months later.

Another document from the above overview site is a copy of a September 16th 2008 letter sent by Hank Greenberg, ex-CEO of AIG, to Robert Willumstad, then Chairman of the Board and CEO of AIG wondering why Greenberg’s offer of help had so far been rebuffed. (Scroll down on the page <http://www.businessinsurance.com/article/99999999/PAGES/1156> to see this letter.)

Also of interest is this link to a letter sent on October 30, 2008 by Greenberg to then CEO and Chairman Edward Liddy, suggesting that AIG be permitted to participate in a TARP-like program whereby the current Federal loan would be converted into a senior preferred security, thereby reducing the need to sell assets in a rapid, fire-sale manner:

<http://www.businessinsurance.com/assets/htm/greenbergletter103008.htm>

An article from April 2009, written on the occasion of Hank Greenberg’s invitation to Washington to help make sense of the AIG mess, notes that Greenberg was responsible for supervising Joseph Cassano, chief of AIG's Financial Products (FP) unit, whose sales of uncollateralized credit-default swaps brought down the company. Greenberg has also been criticized for allowing a culture to develop that completely contradicted the insurance-company ethic of limiting risk. See

<http://www.time.com/time/business/article/0,8599,1888973,00.html>

As an addendum to Hank Greenberg’s story, on July 8, 2009 he was absolved by a jury trial from any responsibility in the split of Starr International from AIG in 2005. Greenberg had been accused of “stealing billions” in that action:

<http://www.time.com/time/business/article/0,8599,1909199,00.html?loomia_si=t0:a16:g2:r1:c0.0873087:b23596288&xid=Loomia>

Before the economic troubles hit in 2008, AIG was one of many financial services companies advertising to market themselves as legitimate and prescient partners in money-making ventures. See the following **video** advertisement, ironic now, which says, in part, “If nobody takes chances, if nobody pushes the boundaries, if nobody takes a stand, nothing great happens...AIG - Insurance financial services—and the freedom to dare.”

<http://www.youtube.com/watch?v=y86B9E1Vtr0>

One of the arguments made for giving the Financial Products executives their bonuses was that it would keep them happy and willing to do the work they were hired to do. In July 2009, when the second bonus payment was made, one recipient reported, “I was definitely feeling negative about the economy last year, when I lost the company billions of dollars and all,” says Josh Harbock, an AIG executive who just cashed a seven-figure bonus check. “But now I'm starting to feel like things are beginning to turn a corner. I was tightening my belt the last few months, but now I think I'm going to buy a house in the Hamptons,” he says. But even though Mr. Harbock believes that the stimulus package has succeeded in sparking the economy, he feels that a second stimulus may be needed. “Let's face it, my bonus check is not going to last forever,” he says. “And frankly, I'd like to buy a boat.” (This is from an article by comedian Andy Borowitz, see link below.)

<http://www.huffingtonpost.com/andy-borowitz/aig-bonus-recipients-upbe_b_230892.html>

After the fact, ex-CEO of AIG Hank Greenburg pointed a finger at the banks and other financial institutions who took their insurance money from AIG after the government bailout: “AIG said it had paid out about $50 billion to various financial firms to which it had sold credit-default swaps, which are insurance contracts sold to bond investors and others. When a bond defaults, a holder of a CDS has the right to be reimbursed for the loss by the seller of the contract. AIG was one of the largest sellers of such contracts. Much of the credit insurance AIG sold was on mortgage bonds, which are backed by home loans. As more and more homeowners defaulted, many of those bonds plummeted in value, causing the holders of AIG's CDS contracts to request payment. AIG used money it had received from the government to pay off those contracts.”

“Now (in April, 2009) Greenberg and others argue that AIG should not have made good on many of those contracts. These critics say it should have been obvious to the sophisticated financial firms who bought that insurance that AIG had no ability to pay out on such claims. So when AIG ran out of money, buyers of its insurance should have been forced to settle those claims for a fraction of what they were due. Instead, AIG took money from the government and paid the claims in full.” See <http://www.time.com/time/business/article/0,8599,1889149,00.html?xid=rss-topstories>

It appears from the above that Hank Greenberg may have consistently tried to provide direction to the company. What does the above say about the role of strategic leadership?

Here is a link to a Time Magazine article from March 19, 2009 containing a detailed report on the overall AIG situation:

<http://www.time.com/time/business/article/0,8599,1886275-1,00.html>

In August 2009, newly appointed CEO Robert Benmosche said he believed AIG would be able to pay back the government, and show a return for shareholders. Outgoing CEO Liddy had said the government would likely be paid back in full in 3-5 years. AIG will do this by selling off divisions in its transition from the world’s biggest insurer to a much smaller domestic life insurance company. The company saw a jump in share price of 31% on this news, but, still, hundreds of millions of dollars in bonuses were yet to be paid to employees in the Financial Products unit. Benmosche’s own compensation was set to be $10.5 million a year in salary, stock options and bonuses. See <http://money.cnn.com/2009/08/20/news/companies/aig/?postversion=2009082014>

Did Benmosche succeed in modeling integrity-based ethics? It doesn’t appear so. Although AIG did manage to “repay” its obligation to the U.S. Department of the Treasury, here’s a collection of news comments on AIG’s situation as of 2013, one of which reports on how Benmosche reacted badly to being told he couldn’t use the corporate jet to go to his granddaughter’s birthday party, and another mentions how he spent a good deal of time at his vineyard in Croatia rather than at AIG company headquarters: <http://dealbreaker.com/tag/robert-benmosche/> Benmosche died in 2015 at the age of 70.

1. ***What controls did AIG have in place, and how did those controls affect its corporate behavior?***

Carefully developed policies and procedures guide behavior so that all employees will be encouraged to behave in an ethical manner. However, they must be reinforced with effective communication, enforcement, and monitoring, as well as sound corporate governance practices and mechanisms of strategic control.

## **Referencing Chapter 9: Strategic Control and Corporate Governance**

*Strategic control* involves the process of monitoring and correcting a firm’s strategy and performance. Students can discuss the differences between a “traditional” and “contemporary” approach to establishing control systems.

In a *traditional control system,* top management formulates strategies and sets goals. These strategies are implemented, and then performance is measured against the predetermined goals. In a *contemporary control system,* managers continually monitor both the internal and external environments, and identify trends and events that signal the need to revise strategies, goals and objectives. Contemporary control systems must have four characteristics to be effective. 1. The focus is on constantly changing information that has potential strategic importance. 2. The information is important enough to demand frequent and regular attention from all levels of the organization. 3. The data and information generated are best interpreted and discussed in face-to-face meetings. 4. The control system is a key catalyst for an ongoing debate about underlying data, assumptions, and action plans. An executive’s decision to use the control system interactively—in other words, to invest the time and attention to review and evaluate new information—sends a clear signal to the organization about what is important. The dialogue and debate that emerge from such an interactive process can often lead to new strategies and innovations.

Students should therefore recognize the importance of involving all operating managers in setting performance goals based on continuous monitoring of the internal and external environment.

In the traditional insurance business, firms such as AIG anticipate risk by using models based on known risk factors (remember that a “risky environment” is one in which information on the environment is not completely available, and decisions are made based on an assessment of the probabilities of the occurrence of events). Therefore, well-learned processes (risk models) are used to set goals, and performance is monitored against those goals – a *traditional control system*. By entering into the credit default swap (CDS) business, AIG had assumed what it thought was negligible risk, but it appeared that the traditional models and controls were not appropriate for identifying the trends that led to eventual financial collapse of this business. (There’s even commentary on how little AIG truly understood the risk that it faced in its own businesses – see <http://www.businessweek.com/stories/2008-09-16/the-unraveling-of-aigbusinessweek-business-news-stock-market-and-financial-advice>.) AIG would have needed *contemporary control systems* to anticipate problems and make appropriate revisions in strategy. The key assets AIG had that could have helped in this process were its managers – its human capital.

Strategic control focuses especially on the roles of informational and behavioral control in the formulation and implementation of strategies. See Chapter 9, Exhibit 9.2. *Informational control* is concerned with whether or not the organization is “doing the right things”, while *behavioral control* is concerned with whether or not the organization is “doing things right” in the implementation of its strategy. Organizations need to make sure enough information of the right kind is available to monitor activities – this is where things such as financial audits and customer feedback is essential; and where appropriate role models and rewards should be available to keep employees motivated.

AIG had used information from its standard risk models to determine if it was “doing the right things” to accrue reputation and profits – this had set the stage for the firm’s choice of competitive and corporate strategy, its entry into the financial services and brokerage businesses. Once in those businesses, AIG needed to make sure its employees were “doing things right” in operating and managing those businesses to sustain profitability. AIG’s employees needed to be motivated to do this.

Chapter 9 emphasizes the importance of aligning both informational and behavioral control systems with organizational strategy. The information gained from the internal and external environment is reviewed against the firm’s strategy and goals. If the results are not what was expected, then behavioral controls can be utilized to encourage employees to “do things right” – employee actions can be influenced through building or maintaining a strong positive culture, creating effective reward and incentive programs, and setting boundaries and constraints to minimize improper and unethical conduct (see Chapter 9, Exhibit 9.3).

Jake DeSantis’ letter demonstrates how well AIG had utilized those behavioral controls in the past – he and his employees were committed to the corporation, willing to work for $1 and stay in the organization even while it struggled for stability, based on previous incentives and promises of future rewards. However, when AIG asked employees to repay earnings, it was considered a “breach of trust”, resulting in anger and fear. AIG would not be able to retain any of its valued human assets by instituting these types of behavioral constraints.

1. ***Provide a stakeholder analysis of those affected by the bonus issue. What alternatives are present to prevent or lessen these sorts of events? How effective are external regulations in encouraging ethical behavior?***

*Corporate governance* refers to the need for a firm’s shareholders (the owners) and their elected representatives (the board of directors) to ensure that the firm’s executives (the management team) strive to fulfill their fiduciary duty of *maximizing long-term shareholder value*. In this, students also should recognize that it is important to consider the needs of different stakeholders: investors, customers, employees, suppliers and other stakeholders. Stakeholder symbiosis implies that stakeholders are dependent upon each other for their success and well-being; and that there is a need for organizations to consider the needs of the larger community, and act in a socially responsible manner. For more clarification regarding *stakeholder identification,* see Chapter 1, Exhibit 1.5 for *the diverse stakeholder groups and the claims they make on the organization.*

One party’s actions can impact the success and well-being of a much larger community: AIG and other financial institutions had ultimate responsibility for maximizing long-term value. Stakeholders who had claim on AIG: the *shareholders*, which included employees such as Jake DeSantis; current and future *employees* – many of them would not be willing to work for a company that had broken their trust; *customers*, many of whom were facing financial difficulties themselves and had to wonder if AIG could be trusted to handle their business in the future; the *creditors*,who in this case were the taxpayers, needed to trust they would be paid back; the *government,* both federal and local, who had made financial and political investments in these public companies, and hoped AIG and others would take responsibility for their actions both now and in the future; the Wall Street *community* which had to wonder if AIG had set the stage for further interference by the government – would the government step in again to dictate how rewards should be configured and distributed?

The instructor might encourage students to come up with additional arguments to identify which of these stakeholders were the most important, and whether the bonuses should have been paid.. The instructor can consider forming debate teams where one team takes the point of view of the shareholder/tax payer, and another represents the managers/employees. Which group is most important here? Who had the better argument? Possible answers include:

*U.S. Taxpayers* were concerned about possible misuse of the bailout loans and the accountability of the firms who received these loans. U.S taxpayers could be considered the most important because AIG had shown that it was already misusing funds when it failed to cancel extraneous “trips” for its executives. Providing bonuses on the scale AIG proposed continued this pattern – signaling misuse particularly in light of the 5 million U.S. taxpayers who were then unemployed. The U.S. taxpayer interest also aligned with the U.S. government in monitoring loan misuse and creating more accountability for firms using Federal money. It begs the question: Are other firms also misusing their funds?

*Edward M. Liddy, AIG’s CEO* was concerned about keeping AIG financially viable and out of bankruptcy, in this sense looking out for the *shareholders*. Edward M. Liddy was the most important stakeholder because he was facilitating the bailout process and maintaining AIG. Mr. Liddy made an incredibly tough decision to go forward with the bonuses, as noted in the letter from Mr. DeSantis. While it appeared to outsiders that this was a gross misuse of funds, Mr. Liddy was upholding a contractual agreement with his managers that facilitated the recovery from the CDS problem. The bonuses were one component of the AIG commitment to the bailout because they redirected salaries from some managers directly to the CDS recovery plan in tandem with the Federal loans. This helped keep AIG functional and out of bankruptcy, which was in the best interest of the shareholders and the company.

*AIG Managers and other employees* were concerned about earning a living and keeping a job.AIG managers were the most important because they were stuck in the middle with no one to support them. Mr. Liddy abandoned his managers during questioning before government officials. The taxpayers did not understand *why* the bonuses were necessary, and neither did the U.S. government when it proposed to tax the bonuses at 90%. Many managers worked for a $1 salary and committed their life savings to recuperate from the CDS disaster. Many were not involved in the CDS. Most importantly, AIG promised the bonuses to the managers to compensate them for their loss and likely played a major role in the manager’s commitment to reduced salaries.

An argument can be made that the bonuses were necessary for three reasons:

1. The bonuses were a contractual tool that allowed AIG to redirect managers’ salaries to the CDS recovery plan. This was one component of AIG's and its managers' investment in the bailout process.

2. The managers worked for an annual salary of $1 in response to the bonus offer. These bonuses also compensated the managers for extreme losses of life savings from the CDS problem.

3. Disputes over the bonuses could have led to private, legal contests if they induced managers to work for $1 and then AIG refused to uphold the contract. Disputes like this often tie-up resources in a firm and could complicate the bailout process further if there was a mass exit of employees who felt they were not getting paid and could not rely on AIG any longer.

Using concepts from the last part of Chapter 9, students should also reference the role of external governance control mechanisms. *External governance control mechanisms*ensure that managerial actions lead to shareholder value maximization and do not harm other stakeholder groups. These external controls are outside the control of the corporate governance system. What external control entities were involved in the bonus issue, and how effective were they?

Instructors may have to restrain students from discussing the underlying issue of lack of regulation of investment banking in general, and the credit default swap (CDS) mechanism in particular. Although interesting, this is not the focus of the case. In the AIG situation, the question is whether the government and other external control mechanisms had a legitimate role to play in addressing the bonus payouts.

The U.S. government proposed a 90% tax on any bonuses paid out to employees of firms who received government bailout money. Both New York’s and Connecticut’s attorneys general threatened legal action against the executives who received the bonuses. These punitive actions were legitimate in the sense that publicly elected officials are beholden to their constituents to provide redress for wrongs. The concept of justice implies that laws are passed to protect societal majorities, and that such laws should be enacted and upheld both to ensure that justice is distributed fairly (that everyone should get what they deserve), and that some sort of deterrence or threat of punishment exists to lead people to make different choices in the future. Both of these concepts were involved here.

The main purpose of the tax on the bonuses was to recover misused Federal money distributed for the purposes of a bailout. This was intended to serve as a deterrent for other firms who might have been contemplating similar uses. In addition, it reinforced the control aspect of the Federal loans in the sense that firms utilizing the bailout were not to use the loans frivolously. In a broader sense, the Federal government was signaling there were appropriate uses of the funds, and that extravagant trips and bonuses did not fit in this schema.

Although the government may have felt obligated to act in this instance, due to public and political pressures, external governance controls might not be as effective as controls put in place by companies such as AIG. In the AIG case, students should be urged to consider the implications for all stakeholders. Although the news about the bonus payouts was certainly unpleasant, as Jake DeSantis’ letter points out, these were less “bonuses” than they were deferred salary reimbursements, part of a contractual compensation package intended to “control the behavior” of key AIG executives – if they “did things right”, they’d be rewarded. Perhaps the problem was in how the details of this “reward” mechanism were communicated?

**Secondary Concepts that might be discussed as well:**

**NOTE: there are no Powerpoint slides accompanying this part of the discussion.**

After the discussion of specific case questions, students might benefit from a brief review of how a firm strategizes for competitive advantage – specifically how strategy is derived from an analysis of key activities and resources internal to the firm – both tangible and intangible assets are important to a firm’s choice of strategy.

**Referencing Chapter 4: Assessing Intellectual Capital**

Consider the concepts of *intellectual capital*, *human capital*, and *social capital,* all of which are intangible assets that a company such as AIG needs to have in order to compete successfully. Intellectual capital is a measure of the value of a firm’s intangible assets, its reputation, employee loyalty and commitment, customer relationships, company values, brand names, and the experience and skills of employees. How do companies create value in a knowledge–intensive economy? The general answer is to attract and leverage human capital (intangible assets) effectively through mechanisms that create products and services of value over time.

Human capital involves the individual capabilities, knowledge, skills, and experience of the company’s employees and managers. This knowledge is relevant to the task at hand, and also includes the ability to add to this reservoir of knowledge, skills, and experience through learning. Human capital is the foundation of intellectual capital. Intellectual capital is developed through attracting, developing, and retaining human capital. See Chapter 4, Exhibit 4.2.

Success in retaining human capital could also be attributed to the nurturing of the “social ties” or *social capital*.Social capital includes the network of friendships and working relationships between talented people both inside and outside the organization. Relationships are critical in sharing and leveraging knowledge and in acquiring resources. Social capital can extend beyond the organizational boundaries to include relationships between the firm and its suppliers, customers, and alliance partners.

AIG had built itself up to a global insurance giant by acquiring and developing assets that were essential to its performance. Given the nature of AIG’s business, most of those assets were human ones. In a business dealing primarily with information, AIG’s major assets were the skills, knowledge, and experience of its employees and managers. Attracting, developing, and *retaining* those assets was critical to AIG’s success!

# **Referencing Chapter 10: Creating Effective Organizational Designs**

*Organizational structure* refers to formalized patterns of interactions that link a firm’s tasks, technologies, and people. Structures help to ensure that resources are used effectively in accomplishing an organization’s mission. Structure provides a means of balancing two conflicting forces: the need for the division of tasks into meaningful groupings, and the need to integrate the groupings for efficiency and effectiveness by coordinating and integrating key activities.

Structure identifies the executive, managerial, and administrative organization of a firm and indicates responsibilities and hierarchical relationships. It also influences the flow of information as well as the context and nature of human interactions.

Factors that facilitate the effective coordination and integration of key activities include having a common culture and shared values, horizontal organization structures, horizontal systems and processes, effective communications and information technologies, and involved human resource practices.

An effective organizational design can encourage the flow of information and enhance working relationships between functional departments and activities. However, achieving the coordination and integration necessary to maximize the potential of an organization’s human capital involves much more than just creating a new structure. Different structures lead to different degrees of flexibility and permeability, and can affect the amount of culture change required. Structures can have an impact on relationships between internal and external constituencies, and therefore need the full support of the management team to implement.

In the case of AIG, the firm was in trouble because of the actions of just one of its divisions, Financial Services. As of 2013, AIG is in several lines of business, primarily property casualty, life and retirement, and, currently, global asset management. The troubled financial services division has been sold off in various pieces, and the firm has consolidated its areas of business to focus on its insurance industry base.

The original structure of the firm was meant to enhance the overall operation of the insurance business, coordinating and integrating the various activities so each could benefit from the tasks, technology, and people involved. Although it appears that the mortgage insurance business was a legitimate offshoot of the organization’s overall strategy, the actions of its London unit, which had sold credit protection in the form of credit default swaps (CDSs) on collateralized debt obligations (CDOs) backed in part by subprime loans, put the firm at significant risk in 2008 when the value of these assets plummeted during the overall financial melt-down.

In this case, the actions of that one division had a significant impact on relationships between internal and external constituencies, and on the ability of the firm to support its overall business.

See <http://www.theofficialboard.com/org-chart/american-international> for a current organizational chart of AIG. Compare that with the expanded chart from 2008 at <http://s.wsj.net/public/resources/documents/WSJ_AIG_organization092109.pdf> which shows Financial Products in addition to the life insurance, retirement services and property casualty businesses.

**NOTE – ADDITIONAL READING, VIDEO NEWS STORIES:**

By April 2009, the outrage in Congress over the AIG bonuses seemed to be lessening:

<http://www.politico.com/news/stories/0409/20844.html>

And by July 2009, AIG was planning to issue its second round of bonuses to Financial Products executives, and was asking Kenneth Feinberg, appointed by President Obama to oversee compensation of top U.S. executives involved in federal bailouts, for advice. Objectives were to execute AIG’s restructuring successfully, to repay taxpayers, to reduce risk and to successfully wind down the Financial Products division without losing the employees necessary to make this happen:

<http://www.washingtonpost.com/wp-dyn/content/article/2009/07/11/AR2009071100419.html?hpid=moreheadlines>

See a July 2009 **video** report about this, and whether bonuses work to retain employees, here:

<http://www.youtube.com/watch?v=u3FNaHTke0w>

Many people have made suggestions about reducing “excessive” executive compensation, such as increasing shareholder’s influence, reducing board members’ multiple roles and membership on multiple boards, addressing flawed compensation committee decisions and senior executives’ overall failure to manage corporate risk. How much should external stakeholders, such as the Administration and Congress, be involved in the regulation of corporate governance mechanisms?

What does the AIG story tell us, ultimately, about the role of corporate governance?

1. ***OPTIONAL DISCUSSION QUESTION: Is there any way to reconcile the reasoning behind the bonuses and the government response? Consider if you had complete control over the administration of the bonuses back in March 2009. Draft a plan integrating the best points of the different perspectives.***

NOTE – NO POWERPOINT SLIDES ACCOMPANY THIS DISCUSSION. The teaching notes that follow are provided by the case authors:

For this example, we draw on the dialectical inquiry. This is a conflict-inducing decision making process. In the paragraphs below we outline two alternatives. The government response, which revokes the AIG bonuses, is the **THESIS**. The **ANTITHESIS** is the AIG manager position which contends that the bonuses should be honored.

*Alternative 1. THESIS: Government Position*

The main reasoning behind the government response is accountability and stopping misuse. From the perspective of the government, issuing bonuses to managers of the financial services division is a gross misuse of the bailout funds. This is the second time AIG misused the funds. To prevent further misuse the government needs to increase accountability. To counter the current misuse, since the government cannot simply call the loan due, a tax on the specific misuse is most appropriate.

*Alternative 2. ANTITHESIS: AIG Manager Position*

The main purpose of the bonuses was to compensate managers and to free-up resources going to salaries to use for recovery from the CDS problem. From the perspective of the managers who signed the bonus contracts, the bonuses are legal, ethical, and necessary for the bailout process. The bonuses are legal in the sense that AIG and the managers entered into a specific contract to forego salaries for later compensation through the distribution of bonuses. They are ethical because the managers knowingly committed their personal resources to the CDS recovery and are using the bonuses for a legitimate part of the recovery plan. Moreover, these demonstrate the commitment and good faith efforts of AIG to the bailout process. Without the bonus offerings it is less likely that managers could have undertaken such a commitment to the bailout.

*Alternative 3. SYNTHESIS: Developing a More Optimal Solution*

Alone, these positions do not appear to provide an optimal solution. One of the reasons the positions are in such stark contrast is the lack of transparency. The government did not understand the bonus announcement and the managers, given the promises of AIG, did not anticipate the government, or taxpayers', reaction. To overcome such polarized alternatives you could do three things.

1. You could draft a public document outlining AIG's commitment to the bailout process. In particular, the document should highlight the manager sacrifices by deferring their salaries and compensation to assist in the process.

2. You could relabel the distribution of the bonuses a compensation package or deferred salary reimbursements. Either seems more accurate than a bonus, and may increase transparency of the intent in the eyes of the taxpayer. Bonus often implies a reward given for performance above and beyond normal performance. While one could argue that the managers did a great thing by giving up their salaries, the compensation package is a contractual pay-out that allowed the redirection of salaries to the bailout process.

3. You could communicate with the managers. A pay-out of this nature may meet some public resistance, particularly if AIG does this unilaterally. Under a scenario where there is resistance or one could avoid public embarrassment, since AIG has been under close media scrutiny, it may be better to revisit the pay-out amounts and timing. Large sums are likely to be more controversial than reasonable compensation. This would involve extending the pay period, and likely result in several pay-outs. In an extreme scenario AIG may have to reduce overall payouts.

**Epilogue**

AIG paid over $1 billion in different plans and compensation packages over the course of the year following its initial Federal loan acceptance. Some of this continued to impact the financial services division. DeSantis, like most of the managers in the division, was not involved in the CDS problem. However, the government, concerned with another mismanagement of the Federal funds, assigned a compensation “czar”, Kenneth Feinberg, to monitor payouts after the March mishap.

**Dialectic Teaching Tip**

Many of us can benefit from the dialectical inquiry in our professional and personal lives. A recent conversation with a colleague speaks directly to the potential benefits. His daughter planned a trip to the movies with a few friends on Saturday evening (thesis). However, in the afternoon a neighbor called, desperate for a babysitter for that evening. The neighbor was willing to pay above and beyond the going rate for a babysitter (antithesis).

This is a practical example to explore with students. A possible synthesis is that the daughter could take the babysitting job. She could cancel with her friends and promise to pay for popcorn and drinks next weekend, or even on Sunday.

*Suggestion:* Ask students to reflect on a professional or personal decision that could have benefited from dialectical inquiry.