The Death of Corporate Reputation

BY BOWEN H. MCCOY, CRE

Editor’s Note: the “Viewpoint” column is intended to offer CRE members and others an opportunity to present their viewpoint on a topic that has an impact and/or implications for the real estate industry or other business-related topics.

For more than a century law firms, investment banks, accounting firms, credit rating agencies and companies seeking regular access to U. S. capital markets made large investments in their reputations. They generally treated their customers well and occasionally even endured losses to maintain their reputations as faithful brokers, dealers, issuers and gatekeepers.

Many would conclude that this has changed. Today’s leading capital market participants no longer treat customers as valued counterparties whose trust must be earned and nurtured, but as distant counterparties to whom no duties are required. The rough and tumble norms of the marketplace have replaced the long-standing fiduciary model in U. S. finance. The result has been unrelenting financial scandal.

This change in values has been described in a recent book entitled The Death of Corporate Reputation: How Integrity Has Been Destroyed on Wall Street, by Jonathan R. Macey, professor of law at Yale. The author asserts that reputation matters far less than it used to for three reasons. First, improvements in information technology have lowered the costs of discovering information about people. As a result, individuals involved in the financial markets focus far more on the development of their own individual reputation rather than on the reputation of the companies for which they work. Second, law and regulation serve as a substitution for reputational capital. Participants have come to rely far more on the protections of the law and far less on the comfort provided by reputation. Third, the world of finance has become so complex that the rocket scientists who design complex financial instruments have replaced the simple, high reputation practitioners of “Old School Finance.”

An ironical thesis of the book is that firms that are subject to systematic and pervasive laws and regulations will have weak incentives to invest in developing and maintaining their reputations. Another thesis is that firms will expend human and financial capital maintaining a reputation only so long as there is a payoff in the marketplace for doing so. Firms that can make creditable commitments to clients that they are honest and reliable become more desirable contracting partners and should be able to charge more for their services. Historically, loss of reputation was fatal to accounting firms such as Arthur Anderson, and to law firms like Vinson and Elkins, and to credit rating agencies like Moody’s. Such firms no longer depend on maintaining their reputations as a key to survival. Instead, regulations often require companies that issue securities to retain various Wall Street service providers. Because the demand for the services of these firms is driven by regulations, the firms do not need to maintain their reputations in order to attract business. Thus, reputation is no longer an asset in which it is rational to invest.

The primary purpose of investment in regulation is to assure investors that they can invest with some degree of confidence that they will not be defrauded. Like

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regulation, which is costly, developing and maintaining a reputation for honesty is very expensive. It is more expensive to be honest than it is to be dishonest. Profits-maximizing firms can be trusted to make costly investments in reputation only as long as the investments pay off. If the costs of investing in reputation are greater than the benefits, really honest people will be driven out of business (Gresham’s Law), because businesses lose money by investing in reputation.

The traditional theory of reputation still appears to have more force in the financial world than in the worlds of manufacturing and technology where customers can receive product warranties. Financial markets, trading pieces of paper, have value only when there is an underpinning of trust that the relative value will always be there.

The decline in the value of reputation can be traced to the fall of Drexel. Three critical lessons emerged from the Drexel scandal. The traditional theory of reputation stated that sharp business practices were only mildly profitable. Drexel proved that sharp practices can be enormously profitable. Drexel also showed that the costs of swindling and cheating were far less than had been thought. Employees of companies that lose their reputations survive and thrive performing similar work at other companies. The Drexel scandal proved that individual reputations are no longer firmly linked to the reputations of the firms they work for. Other than the few who go to jail, scandals do not destroy the futures of the people involved in the scandals. Criminal indictments remain a horrific event, but civil indictments, even when brought by the SEC, have lost most of their shaming effect. Finally, the traditional theory of reputation was that people and companies have a single, unitary reputation. That theory has fallen to the immense rise in individual autonomy and free agency.

Macey asserts the regulatory environment over-enforces highly technical rules and under-enforces simple fraud, thereby undermining the reputational signaling of SEC action. All major investment banks and accounting firms have been involved in litigation, destroying the ability of investors to use regulation as a means of identifying good or bad companies. The firms also settle nearly all the cases brought against them without admitting wrongdoing, further complicating the information that investors can infer from regulation. As a result, regulation has become decoupled from reputation in modern financial markets.

For decades the SEC has kept the insider trading rules vague and undefined. This ambiguity increases the SEC’s power and enables government lawyers to pick and choose among prosecution targets. Large brokerage firms expend huge resources in order to gain informational advantages over their competitors. Some of this informational advantage is legal, some is not. The government purposefully fails to provide clear guidance as to what is illegal insider trading and what is legitimate, aggressive research.

A reasonable interpretation of the traditional theory of reputation is that reputation is so important to the operation of the financial markets that such markets could virtually disintegrate and perhaps even cease to operate in the absence of trust. Unknown companies that wanted to raise capital by selling their securities used to be able to “rent” the reputations of powerful reputational intermediaries such as accounting firms, law firms, credit rating agencies and investment banks. People are also more willing to trust others with whom they share common characteristics such as culture, ethnicity, national identity and creed. As communities become more diverse, people tend to trust each other less.

My own experience was that of a “legacy partner” of a major investment bank where I was employed from 1962 to 1990. The early days were Dickensian, when we underpaid apprentices filled out huge sheets of yellow accounting papers with calculations made on electromagnatic calculators. The senior partners did not bother to learn our names. I don’t know how we survived it, but it was mainly through humor and shared misery. Yet the firm’s values became deeply imprinted on each of us. As one of our founders once stated: “We shall do only first-class business, and that in a first-class way.” Our work product had to be error-free and excellent. Everyone paid attention to the details. There were no short cuts. The clients’ interests were put before those of the firm. Teamwork was vital. We were a true partnership, meeting all together twice a week, most of us owning equal percentages of the business. It was unthinkable to let the partnership down. We were the firm. We lived it out.

When I joined the firm, there were 140 employees. When I was elected a general partner eight years later, there were 250 of us. Today the firm numbers more than 55,000 employees. In the smaller firm, it was far easier to communicate and live out values. In the annual
promotion cycle, each of the candidates was well known to those making the decisions. It was possible to rank order candidates and maintain consistent standards. Today, in the large remaining banks, it is promotion by assertion. The New York-based senior officers cannot be expected to know candidates located in India or Hong Kong or Des Moines. Likewise, it is difficult to transmit and engender a coherent culture. All the major banks have been sued for insider trading or other securities law violations. Fifty years ago it was possible to describe individual banks or accounting firms by their unique cultures. Today all the monolithic banks appear the same. It is interesting that Bill Hewlett and Dave Packard, founders of Hewlett Packard, felt that the largest business unit that could sustain their culture as they grew was 1,000. When a group reached that size, it was hived off to a new location.

The focus in the finance industry at present seems to be on establishing rules for regulation, negotiating rules, bending rules, getting around rules and the like. Responsible leadership involves living beyond the rules, living out personal values, respecting clients and customers, and educating the young people in our businesses on responsible leadership. Rather than trading off, compromising, maximizing outcomes, placing personal autonomy ahead of the group, values-based leadership changes the focus to: what are we willing to lose for? As Professor Macey points out, cheaters do prosper.

In my spare time I attempt to facilitate discussions of business ethics among MBA students. I emphasize the value of reputation to a firm and the need to constantly renew and reinforce values. I ask them, as professionals, what responsibility they feel they have in promoting values and good practice. I ask them to assume they are CEO of a company that has just been raided. You are frightened, angry and concerned about the loss of your large salary, corporate jet, tickets to Super Bowl and the Masters. First thing you must do is hire an investment banker to mount your defense. It comes down to two firms. The first has a stellar reputation and a fairly good record in takeover defense. The second is known as being a little sharp, playing it close to the edge, pushing the murkier aspects of the law, but it has the best record in defending companies. Which would you choose? The vote is usually two to one in favor of the edgier firm with the best record. I conclude the discussion by asking them what responsibility do they feel they have, as well educated professionals, to protect and raise the standards of American business? How do things ever get better?

The role of a true leader is to help clear away the debris and focus on the primary issues. It is to develop an orderly procedure for prioritizing important issues. It is to evaluate, admire and defend good practice and to critically and objectively evaluate bad practice. It is to create an atmosphere of professionalism and calm in the midst of controversy. It is, as usual, to help guide our associates to do the right thing.