Corporate Culture: Changing Board Responsibilities and Changing Governance Rhetoric

Alice Belcher
Professor of Law, School of Social Sciences, University of Dundee, United Kingdom, c.a.belcher@dundee.ac.uk

ABSTRACT: The UK’s Financial Reporting Council is telling directors that they should not wait for a crisis before they focus on company culture. The board must set culture, embed it, assess it and report on it. This paper traces the company’s formal legal liability for corporate culture as imposed in Australia and the UK and investigates the new focus on corporate culture in the wake of some notable corporate crises. It uses the Volkswagen emissions scandal as an example of cultural misalignment where the company and individual employees below board level (rather than a board collectively, or board members individually) have been the ones to be found liable despite the increase in rhetoric about the directors’ responsibility for corporate culture. This critique is put into the context of decades of Management research in the field of Corporate Culture that has produced theory, empirical results and an array of practitioner tools, but has also ignited debates so intense as to be labeled the “culture wars”. The paper points up the care that will be needed as legal liability for corporate culture increases before there is a consensus among management scholars on what it means and how it can be measured or assessed.

KEYWORDS: Corporate Culture, Directors, Governance, Law and Management, Responsibility, Volkswagen

Introduction

The preface to the 2016 edition of the UK Corporate Governance Code (the UK Code) stated that one of the board’s key roles is establishing their company’s culture (FRC, 2016a, preface para 4). The 2018 edition of the UK Code states that the board should assess and monitor culture (FRC 2018, provision 2). The propositions made in the paper are that; 1) there are forces operating within UK statute law and in relation to the UK Code that are making increasing demands on directors regarding their company’s corporate culture; 2) The demands go beyond a responsibility to set corporate strategy and corporate policies, with the directors becoming increasing responsible for “embedding” approved behaviours across the whole workforce; 3) These demands are being made against a lack of consensus in the academic literature on corporate culture that extends to its definition, its theoretical bases, ways of assessing it and the usefulness and comparability of such assessments; 4) That a misalignment between outward-facing claims about corporate values and internal workforce behaviours can produce a reputational crisis such as that experienced by Volkswagen following “dieselgate” in September 2015, and finally 5) That when boards implement the 2018 UK Code requirement to monitor and assess corporate culture they need to be aware of culture’s conceptual and measurement difficulties.

The increasing demands of statute law

One purpose of this paper is to highlight the legal technicalities associated with “corporate culture”, especially as it can impact on the legal liability of a company, the company directors and some employees. The earliest statutory use of “corporate culture” only applies to the first of these; the liability of the company itself. In 2007 UK law referred to corporate culture by including the phrase “… attitudes, policies, systems or accepted practices within the organisation” in section 8(3)(a) of the Corporate Manslaughter and Corporate Homicide Act 2007. “Policies” and “systems” can be written down and approved by the board whereas “attitudes” and “accepted practices” are behavioural elements that are more difficult for the board to know about throughout its organisation and even more difficult for it to control. The first statute to use the phrase “corporate culture” explicitly was the Australian Criminal Code Act 1995 (consolidated as of June 7, 2010) part 2.5, section 12.3(6) where corporate culture is defined as “an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate in which the relevant activities take place.”
Section 12.3 of the Australian Criminal Code states:
“12.3(1) If intention, knowledge or recklessness is a fault element in relation to a physical element of an offence, that fault element must be attributed to a body corporate that expressly, tacitly or impliedly authorised or permitted the commission of the offence.

(2) The means by which such an authorisation or permission may be established include: (a) …; or (b) …; or

(c) proving that a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to non-compliance with the relevant provision; or

(d) proving that the body corporate failed to create and maintain a corporate culture that required compliance with the relevant provision.” (emphasis added)

These provisions and the equivalent provisions of the UK’s Corporate Manslaughter and Corporate Homicide Act 2007 (the 2007 Act) can be used to attribute criminal liability to the company itself. Directors can cause their company to commit a crime through their management, or mismanagement, of the corporate culture. In Australia the relevant statute applies to all crimes that require intention. However, the Australian statute is a piece of Commonwealth legislation (Federal level) whilst prosecutions are, more usually, brought under the law of an individual State. At the time of writing there is yet to be a prosecution under the corporate culture provisions at a Federal level. At State level, the Australian Capital Territory (ACT) has reproduced the corporate culture route for attribution of corporate criminal responsibility. It has also enacted the Crimes (Industrial Manslaughter) Act 2003. When the ACT corporate culture attribution of criminal responsibility is coupled with the (State level) crime of industrial manslaughter the effect is to link mismanagement of a company’s culture with the possibility of a conviction for a form of corporate manslaughter; a result similar to the convictions now possible in England and Wales (for corporate manslaughter) and in Scotland (for corporate homicide). But, ACT is home to only 1.5 per cent of the Australian population, has no heavy industry, and most of its employers and employees are government departments and public servants who, as such, are exempt from the provisions of the 2003 Act.

Given the seriousness of a corporate manslaughter conviction, the use of “corporate culture” in the attribution of corporate criminal liability might have been a driver for every boardroom to focus on the culture they were shaping, or were permitting to exist in their company. Whilst UK boards noted the enactment of the 2007 Act, the corporate culture aspect of the new crime was not acted on with any urgency. It appears that it might take a “big” prosecution to hammer home the legal risks associated with the mismanagement of corporate culture under the 2007 Act. This might be the prosecution of a very large company, or a prosecution following a significant disaster, for instance there has been an indication that the 2007 Act may be used following the Grenfell Tower fire in London in which 72 people died. It has been other forms of corporate scandal where the mismanagement of corporate culture has come to the fore, with Volkswagen’s diesel emissions scandal being notable example.

The UK Corporate Governance Code

The introduction of the UK Corporate Governance Code in 1992 and its subsequent revisions have produced significant changes in UK boardrooms in the shape of many more non-executive directors, a general acceptance of the new norm that these non-executive directors will be used to form various governance sub-committees of the board, and a new general awareness of governance issues as matters to be evaluated, discussed, reported and improved. For listed UK companies the Financial Reporting Council (FRC) is the body that now sets the agenda for consultations and leads on the development of new UK Code provisions. The effectiveness of a voluntary UK Code that adopted the “comply or explain” mechanism to encourage compliance has been remarkable. It has been effective not only in producing change in the boardrooms of listed UK companies, but also through the diffusion of its general principals across the world and across different types of companies (Belcher 1996). The UK Code has been through many developments with most Code revisions bringing incremental change and only a few deserving to be described in terms of a significant shift.
From 1992 to around 1999 UK Corporate Governance Best Practice can be seen as system-based. It was a set of rules that, if followed, might prevent executive directors from abusing their power. This was done by inserting an extra set of independent voices capable of challenging those executives. It was not dependent on the directors behaving well; it was rather a system devised with potentially badly behaving (executive) directors in mind. From about 1999 onwards a change can be detected. Under a Code development in 1999, boards had to decide on a risk management policy for their company and the directors were asked to ensure that the chosen policy was embedded throughout the company with an “emphasis on changing behaviour” (Jones and Sutherland, 1999, 21). Boards were encouraged to ask: “Does the company communicate to its employees what is expected of them and the scope of their freedom to act?” (Turnbull 1999, appendix). From this point on corporate governance best practice in the UK has been increasingly expressed as a set of systems and behaviours (Belcher 2014, 38).

The 2018 UK Code marks another shift. It has been hailed for being shorter and sharper, but another of distinct feature has been the influence of the directors’ statutory duty to promote the success of the company:

“A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole and in doing so have regard (amongst other matters) to—

(a) the likely consequences of any decision in the long term,
(b) the interests of the company’s employees,
(c) the need to foster the company’s business relationships with suppliers, customers and others,
(d) the impact of the company’s operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company” (Companies Act 2006, section 172 (1)).

This duty, leaves the benefit of the shareholders (members) of the company at the heart a director’s decision-making, but is explicit about the need to have regard to the company’s relationships with its other stakeholders in pursuit of the long-term success of the company. This approach is called “enlightened shareholder value”. The stakeholders are not given any legal standing to challenge a director’s decisions. The company remains the legal person with standing to sue for any damage caused by a breach of the duty, but with the possibility of a derivative action where shareholders can ask the court to effectively force the company to sue a wrongdoing director where the directors do not themselves initiate an action by the company against the wrongdoer. With legal actions by stakeholders impossible, and legal actions by shareholders difficult and expensive to initiate, enforcement of section 172 appears problematic. On the basis that information can bring about shareholder activity, the Companies (Miscellaneous Reporting) Regulations 2018 (SI 2018/860) introduced a new reporting obligation (for large companies), called a “section 172(1) statement.” A strategic report for each financial year which “describes how the directors have had regard to the matters set out in section 172(1)(a) to (f) when performing their duty under section 172” is required (Companies Act 2006 section 414CZA, also referred to in FRC 2018, provision 5). Provision 5 of the 2018 UK Code combines this reporting requirement with a requirement to understand the views of the company’s key stakeholders through “engagement mechanisms”, and (most controversially) a requirement for engagement with the workforce using formal methods. “[O]ne or a combination of the following methods should be used: a director appointed from the workforce; a formal workforce advisory panel; a designated non-executive director is required” (FRC 2018, provision 5).

The overt references to the section 172 duty in the 2018 UK Code parallels the introduction of the “section 172(1) statement”, but the influence of the section 172 duty was also foreshadowed in the work done under the umbrella of the FRC’s “Culture Coalition” during 2016. Whilst the introduction
of the UK’s 2007 Act did not cause boards to focus on corporate culture, by 2016 boards were found to be spending more time discussing values, behaviours and culture than they had been five years previously (FRC 2016b, 8). News of the Volkswagen emissions scandal broke in September 2015, which may go some way to explaining boards wanting to discuss corporate culture in their meetings and to explaining the FRC’s decision to set up its culture coalition. The coalition included partner organisations representing for instance, personnel managers and accountants. Research work was reported by coalition partners in 2016 (for instance FRC 2016b, CIPD 2016). In its 2016 report *Corporate Culture and the Role of Boards* the FRC employed a definition of culture that referred to the very stakeholders that are referenced in the section 172 duty:

“Culture in a corporate context can be defined as a combination of the values, attitudes and behaviours manifested by a company in its operations and relations with its stakeholders. These stakeholders include shareholders, employees, customers, suppliers and the wider community and environment which are affected by a company’s conduct.” (FRC 2016b, 6).

This definition did not survive into the 2018 UK Code, but it establishes how a company’s culture can include both its outward facing pronouncements about its values and its internal management of operations where those values need to be embedded. It impliedly connects the legal obligation for boardroom decisions to be made using the enlightened shareholder value approach with corporate culture. The corporate culture provision in the 2018 UK Code retreats somewhat from the idea of corporate culture as present in all of a company’s relationships and uses a definition that is closer to the law on attribution of corporate criminal responsibility:

“The board should assess and monitor culture. Where it is not satisfied that *policy, practices, or behaviour* throughout the business are aligned with the company’s purpose, values and strategy, it should seek assurance that management has taken corrective action” (FRC 2018, provision 2, emphasis added).

Thus, the 2016 definition in which the company’s culture can be “found” in all a company’s relations, has been replaced by a definition that emphasises the possibility of misalignment. The (actual) policy practices and behaviour (that which is to be assessed and monitored), is to be compared with the company’s purposes, values and strategy (that which is to be set at board level and communicated to outside stakeholders).

**Misalignment at Volkswagen**

One of the “highly public” scandals that can be used to illustrate the dramatic consequences of a cultural misalignment is the Volkswagen diesel emissions scandal made public in September 2015. At the heart of this scandal there was the Volkswagen “vision of a hit US diesel car” (Smith and Parloff 2016) pursued by CEO Pischetsrieder until he was forced out in November 2006, and continued as an aim of his successor CEO Winterkorn. The main obstacle to that ambition was that the Volkswagen engineers would need to design an engine that could satisfy the stringent NOx regulations (emissions limits) demanded by the US without sacrificing performance or fuel economy, while remaining competitive on price (Smith and Parloff 2016). It has emerged that engineers had spoken among themselves about the impossibility of the task and the possibility of developing software to cheat the emissions testing system as early as 2005, i.e. before Winterkorn took office as CEO. Winterkorn has been described as “a hard-driving perfectionist.” His ten year strategy for the group, announced in 2008, was that by 2018 Volkswagen would be the “world’s most profitable, fascinating and sustainable automotive manufacturer” (Muller 2013). This ambition meant overtaking Toyota and General Motors to be world number one “not just in units, but in profitability, innovation, customer satisfaction, everything” (Smith and Parloff 2016).

When the engineers could not meet the emissions targets “instead of telling management that they couldn’t meet the parameters, the decision was taken to manipulate. No one had the courage to admit failure. Moreover, the engine developers felt secure because there was no way of detecting the deceit with the testing technology that existed at the time” (Smith and Parloff 2016 citing a whistle-
blower reported in Süddeutsche Zeitung). The action of the engineers in resorting to the manipulation of the NOx emissions controls has been described as “an act of desperation.” The accepted practice of always reporting success to top management, because failure was unacceptable, led engineers to pursue the appearance of perfection rather than pursuing perfection itself in meeting US emissions standards.

Following “dieselgate” Volkswagen appointed Matthias Müller as CEO and in June 2016 he announced and launched a new group “Strategy 2025” of which he said: “The New Group strategy is not the work of external consultants. It came straight from the heart of our company” (Volkswagen 2016). Setting a new culture and trying to embed it across the Volkswagen group has, however, proved very difficult. In May 2017 Mueller said “There are definitely people who are longing for the old centralistic leadership … [and ] I don’t know whether you can imagine how difficult it is to change the mindset” (Cremer 2017).

In the context of “dieselgate” the first person to be prosecuted was the company itself. It pleaded guilty to violations of the US Clean Air Act and agreed to pay billions of dollars in fines. With a guilty plea the issue of the company’s intent did not need to be tested, but many regulatory crimes do not, in any case, require proof of intent. The next set of people to face indictment in the US were Volkswagen engineers who were not members of the group management or supervisory boards. One man, James Robert Liang pleaded guilty to conspiracy to defraud. Then six men were charged with fraud when all six were all outside the US. In January 2017 one of the men, Oliver Schmidt, was arrested at Miami airport having taken a holiday with a journey via the US. He admitted to conspiring to mislead US regulators and to violating clean air laws, pleaded guilty in August 2017 and was sentenced to penalties at the top end of the relevant sentencing guidelines of seven years in prison and a $400,000 fine. The crime of conspiracy is one that requires intent. Again a guilty plea meant that the court did not need to consider the evidence of that intent, but Volkswagen’s corporate culture, as imposed on these employees, could not be used in their defence or provide justification for their crime. The Volkswagen emissions scandal has illustrated how a misaligned corporate culture can produce very significant legal consequences for a company and for some of its employees, but without any evidence of that poor corporate culture being tested in court.

Corporate culture – a lack of consensus

This paper opened with a definition of corporate taken from statute law. Academic interest in “culture research” as applied to organisations began in the 1970s and was followed fairly rapidly by “culture as a popular management fad” (Chatman and O’Reilly 2017, 201):

“Instead of advancing theory and measurement, [Management researcher] interest turned to helping managers. We believe that this shift in focus may have slowed progress in developing a unifying definition of culture. It may also have contributed to prolonged debates among organizational culture scholars, debates that were so intense that they were labeled (sic) the ‘culture wars.’” (Chatman and O’Reilly, 2017 201)

The phrase “culture wars” was coined by Martin and Frost (2011). In the context of the new corporate culture provision in the 2018 UK Code, the important issues identified and discussed by Chatman and O’Reilly concern the numerous definitions (54 different definitions of “organisational culture” were counted by Verbeke, Volgering and Hessels 1998), the numerous diagnostic instruments (Jung et al. 2009 identified no fewer than 70), and problems associated with the drafting of questions to be asked of employees. Questions were discovered that were too colloquial, that were ambiguous because the employee may not know whether they are being asked for a personal answer (their own attitude), or an assessment of their workplace (how people who work here feel), and that were written so that the socially desirable answer could easily be identified. There is also a more fundamental problem because there are two very different approaches or views of organisational culture. These have been described as functionalist and interpretive. The functionalist approach sees organisational culture as something that can, and should, be manipulated to serve corporate interests. The interpretive approach
sees it as something that emerges; something that is not owned by any group within an organisation but is created by all the organisation’s members.

“A functionalist perspective is ‘top down’ in that it serves the strategic imperative of members of the controlling group. An interpretive perspective represents a ‘bottom up’ approach, and allows for the existence of sub-cultures within an organisation. Most organisations display elements of both approaches” (Glendon and Stanton 2000).

Another problem concerns other concepts close to corporate culture for instance corporate climate. Chatman and O’Reilly found that many of the corporate culture tools they analysed measured aspects of an organisation that are better described as climate. Research on “organisational culture” is rooted in anthropology whereas research on “organisational climate” has developed from a social psychological framework (Glick 1985). Whilst culture is often characterised as an enduring aspect of the organisation with trait-like properties, climate can be conceived as a “temporal manifestation” of organisational culture exhibiting more state-like properties (Cox and Cheyne 2000).

All of the problems identified above suggest that provision 2 of the 2018 UK Code could be very difficult to implement and that an unsophisticated use by a board of, say, the annual staff survey in its assessment of corporate culture is unlikely to prove useful. Also, there is the potential for a gap to arise between the sorts evidence routinely gathered by a company for assessment and monitoring purposes and the corporate culture as “lived” by its employees. The second part of the new provision 2 involves the board checking whether policy, practices, or behaviour throughout the business (i.e. culture as assessed by a culture tool, or in some other way) are aligned with the company’s purpose, values and strategy. The final requirement is for the board to seek assurance that management has taken corrective action where any misalignment is discovered. This assumes that it is always possible to manage alignment, but Volkswagen’s experience of attempting to re-set its corporate culture suggests this is far from easy, and may prove an intractable problem. The most usual way of aligning business operations with strategic aims is for corporate paperwork to demand a record of the strategic aim being pursued against everything that is proposed, assessed, requested or decided. Boards need to be aware that management assurance of “corrective action” will need to go beyond assurances “on paper”. Just as it would have been better for Volkswagen’s CEO and management board to have heard from its engineers that NOx emissions targets could not be achieved (yet), boards need to be open to hearing that “corrective action” concerning cultural misalignment has not achieved the desired alignment (yet). Now best practice is asking boards to gather more information on their company’s culture and to evaluate that information it will mean that there is more evidence available to either defend a board against accusations of failure, or to condemn the board if it fails to put its mind to such matters.

Conclusions

A poor corporate culture can now be used to attribute criminal intent to a company in Australia for any crime requiring intent, and to a company in the UK accused of a corporate killing crime (manslaughter or homicide). However, the evidential burden of the relevant statutory provisions remain to be tested and their enactment did not stir company boards into discussing corporate culture. In contrast, the Volkswagen diesel emissions scandal of 2015 provided a clear example of a damaging corporate culture. By 2016 boards of UK companies were devoting an increasing amount of time to discussing their companies’ cultures and the FRC had initiated the work of its “Culture Coalition.” The 2018 UK Code requires boards to assess and monitor corporate culture check for any misalignment and demand corrective action by management if misalignment is discovered. However, at the same time, the ongoing Volkswagen story is revealing just how difficult it is to change corporate culture. Also, Management research on corporate culture, which has been conducted from as far back as at least the 1970s, is complex and disputed. The functionalist approach sees organisational culture as something that can, and should, be manipulated to serve corporate interests. To the extent that culture can be controlled it is sensible to use it to attribute intent for corporate crime, and it is sensible to have a Corporate Governance Code that makes directors responsible for
their company’s culture. However, the interpretive approach sees corporate culture as created by everyone in an organisation, and as something not wholly controllable from the boardroom. The Management literature also reveals the immense conceptual, methodological and practical difficulties that UK boards will now face as they attempt to assess and report on their company’s culture as required by the 2018 UK Code.

References