

**DO THE EXPERTS LIE?: AN EXAMINATION OF THE IMPACT OF  
EXPERTISE & HIGH STATUS ON ORGANIZATIONAL MISCONDUCT**

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## ABSTRACT

*My dissertation examines organizational misconduct through a process framework. I examine how individual and organizational decision processes interact to increase the potential for organizational misconduct. Individuals apply a quasi-rational assessment and initiate misconduct where the benefits of this behavior sufficiently outweigh the costs. They also utilize frames to structure their decision making. At times an ethical frame is inactive which leads to an amoral decision process that increases the probability of misconduct.*

*Conflict management processes at the organizational level feedback on these individual decision processes to increase the probability of misconduct. Within organizational decision making, conflict must be managed. Organizations specifically limit affective conflict since it highlights value differences and personality conflicts. Ethical confrontation is a form of conflict that leads to affective conflict. As a result, ethical confrontation is disfavored and a norm of ethical conflict avoidance develops. This norm increases misconduct by lowering the subjective costs that quasi-rational decision makers perceive and through limiting ethical awareness.*

*Decision precedents represent an additional conflict management process. Precedents permit organizations to avoid revisiting decisions and focus analysis on whether the precedent applies. This further limits the availability of an ethical frame and grows increasingly problematic as precedents are extended to new contexts. The amoral process that results increases the probability that organizational misconduct will occur. In light of these individual and organizational processes, expertise and high status also increase the probability of organizational misconduct. These attributes independently reduce the perceived costs of misconduct, enhance the power of the avoidance norm, and impact precedent use to increase the probability that misconduct will occur.*

*I test my theory through both a computer simulation and an econometric study. In the simulation I demonstrate significant differences in the levels of misconduct consistent with my predictions. The econometric model also provides strong support for the hypothesis that status is associated with increased levels of misconduct. Finally, I examine the possible impact of partial observability within my econometric data. Using two alternate specifications (detection controlled estimation and triangulation), I demonstrate several consistent findings across these models. This reduces concerns that observability creates bias within my base model.*

## **Dedication**

I dedicate this dissertation to my family. Their love and support made this and all good things in my life possible.

## **Acknowledgements**

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## TABLE OF CONTENTS

ABSTRACT .....	ii
Dedication .....	iii
Acknowledgements .....	iv
Table of Contents .....	v
1 Introduction .....	1
1.1 Overview of the Topic .....	1
1.2 Overview of the Dissertation Structure .....	4
2 Behavioral Process Model of Organizational Misconduct .....	7
2.1 Overview .....	7
2.2 Organizational Misconduct Defined .....	8
2.3 Models of Ethical Decision Making & Organizational Misconduct .....	11
2.4 Behavioral Theory Applied to Organizational Misconduct .....	14
2.5 An Integrated Model of Organizational Misconduct .....	25
2.6 Discussion .....	41
2.7 Conclusion .....	48
3 Expertise, Status & Organizational Misconduct .....	52
3.1 Overview .....	52
3.2 Expertise .....	53
3.3 Status .....	56
3.4 Expertise, Status & Decision Making .....	60
3.5 Expertise, Status & Misconduct .....	64
3.6 Discussion & Conclusion .....	71
3A Appendix to Chapter 3: Simulation Model .....	74
3A.1 Overview .....	74

3A.2	Hypotheses Development .....	74
3A.3	Model Specification .....	77
3A.4	Results .....	80
3A.5	Discussion & Conclusion .....	89
4	Empirical Tests: Relationship between Expertise, Status & Misconduct	93
4.1	Introduction .....	93
4.2	Hypotheses Development .....	94
4.3	Data & Methods .....	101
4.4	Results .....	115
4.5	Discussion .....	121
4.6	Limitations & Conclusion .....	124
5	Empirically Defining Misconduct: The Question of Observability .....	126
5.1	Introduction .....	126
5.2	Issues within Misconduct Data .....	127
5.3	Partial Observability of Misconduct .....	130
5.4	Testing Observability Issues .....	131
5.5	Discussion .....	145
5.6	Conclusion .....	148
6	Summary of Findings, Future Research & Conclusion .....	149
6.1	Summary of Findings .....	149
6.2	Future Research .....	151
6.3	Conclusion .....	152
	References .....	153

## CHAPTER 1 - INTRODUCTION

### 1.1 Overview of the Topic

Modern organizations are remarkably effective and efficient. Many retain global reach and have assembled massive resources and capabilities. While such organizations often create extremely positive outcomes, they also can have a dark side (Vaughan, 1999). Their remarkable effectiveness and efficiency can be applied to ethically suspect behavior as well (Ashforth and Anand, 2003; Palmer, 2008). Even highly successful organizations are not immune to the lure of the dark side (McClean and Elkind, 2003; Eichenwald, 2000; 2005). In light of these facts, research designed to advance our knowledge and understanding of organizational misconduct is both highly relevant and critically important. To this end, my dissertation examines this phenomenon of organizational misconduct. Specifically, I develop a process model of organizational misconduct and examine how the specific attributes of expertise and high status can influence decisions to engage in misconduct.

Organizational misconduct is “behavior in or by an organization that a social control agent judges to transgress a line separating right from wrong; where such a line can separate legal, ethical, and socially responsible behavior from its antithesis” (Greve, Palmer, and Posner, 2010, p. 56). Numerous theories present an individual-level decision process that explains how misconduct results (Rest, 1986; Tenbrunsel and Smith-Crowe, 2008). An important question remains how these individual decisions translate to large-scale organizational-level outcomes. The need exists to better understand how

misconduct grows pervasive within specific organizations (Palmer, 2008; Greve, et al., 2010). Debate continues among researchers about the influence of individual characteristics compared to the impact organizational structure and processes have on misconduct (Pinto, Leana, and Pil, 2008; Trevino and Youngblood, 1990). In general, the literature on organizational misconduct has exhibited “neglect of the role of processes and systems” (Ashforth, Gioia, Robinson and Trevino, 2008, p. 671). The process model I develop here attempts to bridge the divide between individual and organizational level factors and offers an integrated process theory that speaks to how the two relate. Specifically, within my dissertation I seek to marry the ethical decision making literature with the organizational decision making literature of behavioral theory in an integrated process model of organizational misconduct.

One of the contributions of my research is the renewed focus it places on process and the specific role that conflict management plays on organizational decision making. Behavioral theory highlights that conflict is a consistent facet of organizational life that must be effectively managed (Eisenhardt and Zabracki, 1992). Organizational decisions reflect satisfied outcomes that result through a political process in which self-interested coalitions never fully resolve conflict (Cyert and March, 1963). I emphasize two key mechanisms of organizational conflict management that I argue can increase the probability of organizational misconduct. First, I maintain that the avoidance of ethical confrontation can develop into a powerful norm within organizational decision making. This occurs because ethical confrontation leads to affective conflict which can erode the overall quality of decision making and the level of cooperation within the organization (Schein, 1992; Baron, 1988; Tsui, Ashford, St. Clair and Xin, 1995). In light of this,



organizational decision makers avoid or reframe decisions with ethical dimensions in value-neutral terms (Morrill, 1991). This can lead to an amoral decision making process that can increase the potential for misconduct (Tenbrunsel and Smith-Crowe, 2008).

In addition, organizations rely on decision precedents as an additional means to manage conflict (Cyert and March, 1963). Precedents allow decision makers to rely on previous decisions and avoid the need to make the decision anew (Pfeffer and Salancik, 1974). This moves the decision making process from a substantive evaluation of the problem and various decision alternatives to a factual analysis that examines whether the precedent applies. This reduces conflict but can also again foster an amoral decision process that fails to adequately consider the ethical dimensions of problems (Davies and Crane, 2003). The application of precedent can become even more problematic as some precedents are extended to cover circumstances that differ from the original decision context. As a result, the use and extension of decision precedents can also increase the probability of organizational misconduct.

An additional contribution of my dissertation involves the development of the influence expertise and high status can have on the propensity of organizational misconduct. I argue that the attributes of expertise and high status also increase the probability that organizational misconduct occurs. This results for a number of reasons that include the difficulty of monitoring experts' behavior (van Nordenflycht, 2010), perceptions of inequitable treatment on the part of experts (Greenberg, 1987), and the lower potential that experts and high status actors decisions will be challenged or sanctioned given their unique roles within organizations. These relationships are tested

in both a computer simulation and through an econometric study that uses the U.S. investment banking industry as its empirical context.

A final contribution my dissertation provides involves an examination of the issue of partial observability within my empirical data. As noted above, I develop an econometric model based on observed wrongdoing in the investment banking industry. Actors typically try to conceal misconduct to avoid detection and sanction (Baucus and Near, 1991). In addition, social control agents have considerable discretion in their enforcement decisions (Greve, et al., 2010). As a result, available misconduct databases may only partially observe the true level of misconduct that occurs (Feinstein, 1990). This can bias the results of studies that employ this data (Feinstein, 1999; Wang, 2011). Within my dissertation I develop a novel empirical approach labeled triangulation to address these issues. The triangulation method entails the specification of a misconduct profile, the development of hypotheses about why profiled observations are not labeled as misconduct, and subsequent testing of these hypotheses to determine if they are supported. I apply this method to my empirical data from the econometric study and specifically examine the impact of partial observability on the results.

## **1.2 Overview of the Dissertation Structure**

The dissertation is structured as follows. Chapter 2 defines organizational misconduct and provides a review of the literature. Thereafter, I develop a process model of organizational misconduct that draws heavily from the ethical decision making literature and behavioral theory. Chapter 3 continues the theoretical development that motivates the dissertation and examines how the attributes of expertise and high status

can influence organizational misconduct. The general prediction that results from this examination is that both expertise and high status can increase the probability that organizational misconduct will occur. The appendix to Chapter 3 highlights the results of a computer simulation that tests specific hypotheses tied to the theoretical arguments developed in both Chapters 2 and 3. Chapter 4 provides a detailed econometric study of the relationship between expertise, status and organizational misconduct. Chapter 5 revisits the data used in Chapter 4's econometric study to examine the specific issue of observability as it pertains to data on misconduct. The final section provides a brief summary of the findings and suggests some avenues for future research.

Of note, Chapters 2 & 3 develop the broad theoretical foundation for my dissertation. The unifying concept across these Chapters is their focus on misconduct as an outcome of individual and organizational decision making processes. Chapter 2 develops the general theoretical framework that outlines how individual and organizational decision making processes interact in ways that can lead to misconduct. Chapter 3 extends this analysis to incorporate the specific attributes of expertise and status. These two attributes present natural extensions of the general model because they are both characteristics of individuals within organizations that influence how these individuals make decisions. At the same time, status and expertise also factor into organizational decision making in terms of both who is involved in the process and the decision that ultimately results.

Empirical tests of different aspects of the theoretical framework are developed in the Appendix to Chapter 3 and Chapter 4. My theory is tied to a thick organizational context that presents some challenges to study. In light of this, I employ a computer

simulation that allows me to model the individual and organizational processes of interest, including avoidance, precedent use, and the impact of expertise and status on decision making. However, I also wish to demonstrate that my theory retains external validity which precipitates the econometric study found in Chapter 4. Although the structure of this latter study does not allow me to look at the specific considerations of avoidance and precedent use, the context does allow me to investigate how expertise and status impact the incidence of misconduct in a live, well defined setting.

Finally, Chapter 5 examines the issue of observability that is a general concern for empirical work that investigates misconduct (Feinstein, 1990). This analysis relates to the theoretical foundation set forth in Chapter 2 while also serving as a robustness check on the empirical work in Chapter 4. The definition of organizational misconduct I employ requires that a social control agent identifies actions as inappropriate (Greve, et al., 2010). Thus for organization misconduct to represent organizational misconduct, it must be labeled as such and acted upon by a relevant social control agent. This highlights an important theoretical consideration when one examines large datasets of discovered misconduct. Namely, do the decision processes of the social control agent impact the data available to test theory. Within Chapter 5 I examine this specific question through the application of alternative specifications to the data from Chapter 4 which are designed to account for the decision making processes of the relevant social control agent.

## **CHAPTER 2 – A BEHAVIORAL PROCESS MODEL OF ORGANIZATIONAL MISCONDUCT**

### **2.1 Overview**

This chapter develops a formal process model that relates individual and organizational decision making process that can collectively contribute to organizational misconduct. Organizations must maintain both coordination and cooperation to be effective (Siegel and Hambrick, 2005). However, individuals within organizations often maintain competing goals or values (March and Simon, 1958; Cosier and Rose, 1977; Reichers, 1985). As a result, conflict management is a necessary and vital feature of organizational life (Cyert and March, 1963; Brown, 1992; Jehn, Northcraft and Neale, 1999). In particular, affective conflict must be managed and reduced within organizational decision making (Jehn, 1994). Ethical confrontation typically generates significant amounts of affective conflict (Schein, 1992). In light of this, I argue that organizations develop a norm of ethical conflict avoidance within their decision making. Confrontations with ethical dimensions are often avoided or reframed to characterize concerns as either factual disputes or task-related criticisms. This avoidance dynamic can increase the probability of organizational misconduct directly and also foster an amoral decision process where ethical awareness is less likely (Rest, 1986; Tenbrunsel and Smith-Crowe, 2008).

In addition, organizations also manage conflict and facilitate coordination through the use of decision precedents (Cyert and March, 1963). Organizations often employ a process of simple-minded local problemistic search to resolve issues (Vissa, Greve and Chen, 2010). Search is triggered where an aspired level of performance is not achieved

(Schneider, 1992). Organizational search is biased toward the use of previously applied solutions (Levinthal, 1997). These established solutions or decision precedents allow decision makers to economize on cognitive processing and avoid the potential conflict associated with revisiting a prior decision (Cyert and March, 1963; Pfeffer and Salancik, 1974). However, the use of precedent leads organizational decision makers to focus principally upon whether the precedent fits the new context. The underlying content of the decision is not re-examined, and this creates the potential that ethical considerations are submerged (Davies and Crane, 2003). This dynamic grows more problematic as organizations extend precedents to new and varied circumstances (Allan, 1966). An amoral decision process can again result and this enhances the probability of misconduct (Tenbrunsel and Smith-Crowe, 2008).

The chapter is laid out as follows. First, organizational misconduct is defined. Thereafter, a brief review of the relevant decision making literature is provided. The next section develops the idea of a norm of ethical conflict avoidance that I maintain can develop within organizations. Additionally, the process individuals employ to frame decisions at work is discussed. The chapter then goes on to examine the social and collective nature of organizational decision processes. Here the role that precedents play is developed. Finally, the implications of the process model I develop are discussed along with some suggestions to improve organizational decision processes

## **2.2 Organizational Misconduct Defined**

Organizational misconduct is defined as “behavior in or by an organization that a social control agent judges to transgress a line separating right from wrong; where such a

line can separate legal, ethical, and socially responsible behavior from its antithesis” (Greve, et al., 2010, p. 56). Organizational misconduct entails actions deemed illegitimate from an ethical or legal perspective (Harris and Bromiley, 2007). It results from the decisions and actions of organizational members, but often simultaneously advances the perceived goals of the organization (Vaughan, 1999; MacLean and Elkind, 2003). The organization is both the context in which misconduct occurs and also a potential beneficiary of the bad behavior. Organizations influence the incidence of misconduct in terms of their culture and climate, and through the organization’s structural characteristics (Ashforth and Anand, 2003). Organizational misconduct encompasses numerous types of transgressions such as white collar crime, unethical behavior, and rule violations (Szwajkowski, 1992).

A key component of the definition of organizational misconduct involves the role social control agents play. Social control agents “are entities that can make reasonable claims to represent the interests of broad communities of actors, and have capacity to monitor and enforce organizational behavior” (Greve, et al., 2010, p. 78). These agents define the line that separates acceptable from unacceptable behavior and retain substantial discretion over the enforcement of the standards of appropriate conduct (Palmer, 2008). Over time these standards are redefined and behavior that was previously acceptable can subsequently be labeled misconduct (Lemert, 1951; Becker, 1963). In addition, social control agents’ enforcement appetites change (Greve, et al., 2010). As a result, actions that violated standards with few negative consequences at one point in time can trigger significant sanctions at a different point.

The fact that standards evolve is highly relevant and highlights the fact that organizations face uncertainty in regard to many decisions they face (Cyert and March, 1963). In terms of misconduct, the “changing location and blurry character of the line between right and wrong” that results through the definitional and enforcement roles social control agents play “generates uncertainty about where the line between right and wrong is located” (Palmer, 2008, p. 131). In light of this fact, behavior that approaches this line carries significant uncertainty and risk (Greve, et al., 2010). Actions at the margins may violate applicable standards even though this was not the intent of the actors involved (Vaughan, 1999). More problematic is that seemingly permissible actions can be categorized as misconduct ex-post as a social control agent adjusts or clarifies the appropriate standard of conduct (Palmer, 2008).

Finally, organizational misconduct is an outcome of a complex collective decision process (Pinto, Leana and Pil, 2008). It results through the interaction of both individual and organizational processes. On this latter point, organizations are more than situational factors that influence individual decision making. Rather, organizations represent a specific institutional arrangement that create and perpetuate distinct decision making processes in their own right (March and Simon, 1958; Cyert and March, 1963; Shrivastava and Grant, 1985). These organizational processes influence outcomes directly. Thus theories of both individual and organizational decision making are highly relevant to our understanding of the phenomenon of organizational misconduct.



## 2.3 Models of Individual Ethical Decision Making<sup>1</sup>

### *Boundedly Rational Choice*

As a general premise, I assume that individuals making decisions within organizations attempt to invoke a rational decision process, but face important limitations on their ability to do so (Cyert and March, 1963; March, 1991). Rational choice implies that the costs and benefits of all available decision alternatives are assessed and individuals make decisions to maximize the difference between benefits and costs (Becker, 1968; Sz wajkowski, 1985; Kagan and Scholtz, 1984). In this way, individual maximize their own utility through self-interested behavior (Simon, 1955). However, the rational assessment individuals apply is subjective (Arrow, 1963). As a result, cognitive processing limitations (Simon, 1947), individual biases (Kahnemann and Tversky 1979; Nisbett and Ross, 1980) and habituation and inattention (Cialdini, 2001; Palmer, 2008) can impede a complete and accurate assessment of the all the relevant variables.

Under the logic of rational choice, misconduct increases an individual's utility in situations where the expected benefits of this behavior outweigh the expected costs (Arrow, 1963; Hechter and Kanazawa, 1997; Finney and Lesieur, 1982). The probability of misconduct is therefore a function of the potential benefits, the probability of discovery, the probability of punishment upon discovery, and the magnitude of the costs imposed through punishment (Braithwaite and Makkai, 1991). Discovery and punishment remain probabilistic since there are limits on the resources devoted to deter,

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<sup>1</sup> Unethical behavior includes a wide array of acts that violate established norms (Trevino, Weaver and Reynolds, 2006; Warren and Smith-Crowe, 2008). Organizational misconduct, as employed here, represents a form of unethical behavior. Thus the models that discuss ethical decision making are relevant. In essence, misconduct is an outcome that occurs where the ethical decision making process fails to generate an ethical decision that translates to an ethical outcome. While I acknowledge the two terms have slightly different meanings, they will be used interchangeably throughout the discussion that follows.

discover, and punish wrongdoing (Stigler, 1970). As a result, an individual's decision to engage in misconduct is impacted by changes in both the cost-benefit relationship and the probabilities of discovery and punishment (Becker, 1968). Furthermore, individual cognitive limitations and biases can lead to mistakes in terms of the accurate assessments of the costs, benefits, or probabilities (Simon, 1947). Finally costs are not limited to sanctions imposed by control agents, but also include the impact such acts would have on an individual's positive self-image and esteem.

### *Moral Awareness & Decision Making*

In light of the significance I place on the costs and benefits of misconduct, an important question becomes how individuals' define and assess the costs and benefits of distinct decision alternatives. In particular, I am concerned with situations where misconduct is part of the available choice set (Harris and Bromiley, 2007). Rest (1986) posits that a critical component of individuals' decision process is moral awareness. Moral awareness exists where decision makers consciously recognize their actions "affect the interests, welfare, or expectations of other people" (p. 4). Awareness is significant to a rational assessment because it leads decision makers to incorporate the ethical dimensions of a decision in their subjective assessment of both costs and benefits. Where awareness develops, better decisions are generally expected to result (Jones, 1991). However, morally aware decision makers remain free to intentionally elect misconduct and behave immorally if they wish (Valentine and Fleischman, 2003; Tenbrunsel and Smith-Crowe, 2008).

In many situations a complete and unbiased assessment of a decision is unattainable and this can preclude moral awareness. When this occurs, an amoral

decision making process results (Tenbrunsel and Smith-Crowe, 2008). Amoral decision makers fail to factor ethical considerations into their decision making process. Actors that lack moral awareness may still engage in behavior consistent with ethical, legal, and moral requirements. However, the decision process they utilize does not incorporate ethical dimensions in the cost-benefit assessment they employ to arrive at this choice.

The development of moral awareness is influenced by a number of factors. The ethical experience and values of the individual, the moral intensity of an issue, and the ethical infrastructure of the decision environment all impact whether moral awareness results (Jones, 1991; Weaver and Trevino, 1999). How an individual frames a particular decision is also critical to the development of moral awareness (Tenbrunsel and Smith-Crowe, 2008). In this regard, frames shape how decision makers perceive the situation they face, what the individual's role requires within that situation, and the relevant decision rules that apply (March, 1994). Individuals employ multiple frames that include a business frame, legal frame or ethical frame to structure decisions (Tenbrunsel and Messick, 1999). Contextual cues activate distinct frames and different decisions result depending upon the frame that is active (Messick, 1999). In quasi-rational terms, different frames can lead decision makers to assess costs and benefits in different ways, and this can lead to very different outcomes. An amoral decision process results when the ethical frame fails to become active (Tenbrunsel and Smith-Crowe, 2008).

## **2.4 Behavioral Theory Applied to Organizational Misconduct**

### *Overview*

Misconduct within organizations implicates the quasi-rational individual decision making process. However, organizational decisions often require the support and active cooperation of other organizational members (Cyert and March, 1963). At the very least, other members of the organization observe and evaluate an individual's decisions and actions (Tetlock, 1985). Beyond this, organizations represent defined social systems with unique patterns of communication, authority, and responsibility that impose independent decision processes on their constituent members (Simon, 1947). In some instances, misconduct grows so pervasive it becomes appropriate to characterize the organization itself as corrupt (Eichenwald, 2000; 2005; McClean and Elkind, 2003; Kulick, 2005; Pinto, et al., 2008). Thus both individual and organizational processes impact decisions that lead to misconduct.

With some limited exceptions, research on organizational misconduct and ethical decision making has not emphasized process models extensively (Tenbrunsel and Smith-Crowe, 2008; Ashforth, et al., 2008). The need therefore exists to develop and refine such models. In particular, researchers need to effectively theorize the interplay between the individual decision processes and organizational decision processes. In the discussion that follows I draw upon the decision making model of behavioral theory and apply this approach to decisions that result in organizational misconduct. I also theorize how the individual and organizational processes interact in ways that can increase the probability of organizational misconduct.

### *Behavioral Theory of the Firm*

A behavioral theory of the firm is a process model of organizational decision making developed from the work of Herbert Simon, Richard Cyert, and James March. Behavioral theory maintains that organizations are comprised of individuals and groups that actively pursue their own self interest (March and Simon, 1958; Cyert and March, 1963). At the individual level, the theory assumes that actors within organizations intend to invoke a rational decision process, but they face real cognitive limitations on their ability to do so (Simon, 1947). As a result, behavioral theory recognizes that individuals are boundedly rational actors and this impacts decision making in important ways. Boundedly rational actors struggle to make optimal decisions because they can neither identify all possible outcomes, nor process all relevant information (March and Simon, 1958). Instead, decisions are based on a limited set of options that reflect a simplified representation of the environment (Simon, 1955; March and Simon, 1958).

Under a behavioral theory, decision making is generally directed toward the achievement of goals (March and Simon, 1958; Cyert and March, 1963). Goals are “a series of independent aspiration-level constraints” imposed through a bargaining process where coalitions form around particular objectives (Cyert and March, 1963, p.117). Organizations aspire to certain levels of performance based upon their own prior performance levels, expected performance reflected in projections and budgets, and the performance of comparable organizations (Festinger, 1954; Harris and Bromiley, 2007). Organizations generate and adjust performance aspirations upward and downward based upon the information they obtain from short-term feedback (Levinthal and March, 1981; Lant, 1992; Greve, 1998).

Problems are defined as specific instances where results fail to meet aspiration levels (Cyert and March, 1963). Problems drive a great deal of the decision making process and lead organizations to initiate search for alternatives that improve performance in line with aspirations (Greve, 2003). Most search is local in nature as organizations “make small adjustments to test new solutions when they encounter problems” (Chen, 2008, p. 610). Firms that perform well below aspiration levels will adopt riskier behavior (Singh, 1986; Bromiley, 1991; Wiseman and Bromiley, 1996). Where performance exceeds aspirations, the organization generates slack which can facilitate more novel and less responsible forms of search (Levinthal and March, 1981). Over time, search and feedback enable organizations to adapt and apply better approaches based upon experiential learning (Herriot, Levinthal and March, 1985; Levinthal and March, 1993; Baum and Dahlin, 2007).

The bargaining over goals that guides organizational decision making represents a politicized process that exhibits quasi-resolution of conflict (Cyert and March, 1963). Conflict involves situations “in which one party perceives that its interests are being opposed or negatively affected by another party” (Wall, 1995, p. 517). A significant degree of conflict stems from self-interest and the competing goals of organizational actors (Deutsch, 1949; March and Simon, 1958; Cyert and March, 1963; Janssen, Van De Vliert and Veenstra, 1999). Diverse interests within the organization come to support specific goals through political interaction that creates a dominant coalition associated with specific decisions (Cyert and March, 1963). Coalitions can be informal but typically center on shared interests about which the members communicate and initiate action (Stevenson, Pearce and Porter, 1985). Even within coalitions of shared interests,

disagreements can result on the best means to achieve some shared goal, and this also creates conflict (Kabanoff, 1985; Jehn 1997). Furthermore, individuals experience conflict with others in the organization based largely on personal differences (Jehn and Mannix, 2001). Under a behavioral approach, conflict between organizational actors is a constant facet of organizational life that must be managed if the organization is to remain effective (Eisenhardt and Zbaracki, 1992; Amason, 1996; Jehn and Mannix, 2001). This ever-present conflict is also quite dynamic, with goals and interests subject to considerable evolution over time (Barney and Hesterly, 2006).

Organizations manage conflict through a number of methods that include local rationality, sequential attention to goals, satisficing, and the reliance on rules and precedents. Local rationality involves the division of problems into sub-problems that are assigned to distinct organizational units for resolution (Cyert and March, 1963). This “reduces a situation involving a complex set of interrelated problems and conflicting goals to a number of simple problems” (p. 118). It enables decision makers to focus attention on a limited set of considerations and information (March and Shapira, 1987). Sequential attention is “a form of quasi-resolution of conflict that lets decision makers treat different goals as constraints to be satisfied in some order or priority rather than as trade-offs that need to be weighted against each other” (Greve, 2008, p. 480). Competing goals are therefore not attended to simultaneously and sequencing is a function of both the preferences of the dominant coalition and short term feedback (Cyert and March, 1963; Augier and March, 2008).

Satisficing targets acceptable-level decision alternatives (Simon, 1947). Under this approach the first minimally acceptable solution to a problem is adopted (March and

Simon, 1958). It is important to observe that Cyert and March (1963) introduce the concept of satisficing as a means of organizational decision making in their discussion of conflict management. In this regard, satisficing is not simply a strategy boundedly rational decision makers deploy to manage their cognitive limitations. It is a strategic approach utilized to manage conflict. Satisficing is necessary because optimal decisions are not practicable, but decisions must still be made and supported across diverse organizational coalitions comprised of self-interested actors (Cyert and March, 1963). Acceptability, however, is very different from agreement (Barnard, 1938). It implies only that individuals are willing to live with the decision and allow it to stand as the organizationally dictated response. Along these lines, individuals within organizations recognize they remain accountable to others for their decisions and adherence to the acceptability criterion represents “the simplest way of coping with accountability” (Tetlock, 1985, p. 311).

Finally, a great deal of decision making within organizations is governed by simplified rules, standard operating procedures and precedents (Cyert and March, 1963; Chen, 2008). I define precedents as any prior decision made within an organization. Precedents are slightly different from rules and routines which exhibit compulsory properties within organizations and “stipulate how organizational participants should perform tasks” (Palmer, 2008, p. 115). In contrast, precedents are prior decisions that are available to organizational decision makers to justify their future decisions within the organizational setting. They are highly relevant within decision making due to the process of problemistic search and their propensity to reduce conflict within



organizational decision making. The reliance on an established precedent is also a means to justify and defend a decision.

Precedents manage help conflict because they eliminate the need to revisit the logic of previously-made decisions (Pfeffer and Salancik, 1978). These solutions have already met the satisficing criterion and have generated acceptable feedback in the near term. Precedents also reduce uncertainty and aid coordination across sub-units of the organization through increased predictability of action (Augier and March, 2008). Notably, specific rules and norms often develop within organizations about how to best manage conflict between organizational members (Thomas, 1988; Morrill, 1991). One such norm that develops within many organizations involves the avoidance of issues that are likely to generate excessive or particularly dangerous forms of conflict among organizational actors (van de Vliert, 1990; Murnighan and Conlon, 1991).

### *Ethical Conflict*

Research on organizational misconduct has recently begun to consider the impact behavioral considerations such as goals and aspiration levels have on the decision to engage in misconduct (Harris and Bromiley, 2007; Palmer, 2008; Mishina, et al., 2010). Where organizations fall short of their performance goals, misconduct can result as a means to close the performance gap and bring results in line with aspirations (Harris and Bromiley, 2007; Mishina, et al., 2010). Such effects are particularly strong when the gap between goals and performance is small (Schweitzer, Ordenez and Douma, 2004). Framing effects and loss aversion (Kahneman and Tversky, 1979) can also impact how aspirations drive misconduct. Highly successful organizations face substantial pressure

to maintain a high level of performance, and misconduct results to avoid results that are perceived as a “loss.” (Mishina, et al., 2010).

These applications of behavioral concepts provide extremely interesting insights into the process that drives organizational misconduct. In essence misconduct comes to be viewed as an available alternative within an organizational actor’s choice set. It is a response that is available to members of the organization to address the problem of unmet aspirations. Harris and Bromiley (2007) note that “explicitly acknowledging misconduct as part of the choice set” alters the outcomes one expects from the organizational decision making process” (p. 352). In addition to aspirations and goals, I argue that conflict and organizational conflict management processes play a critical role in organizational decisions that lead to acts of misconduct.

Generally, excessive conflict creates significant threats to organizational effectiveness (Amason, 1996; Jehn, 1997). In broad terms organizations require cooperation among their members to create value and achieve goals (Child, 1972; Tjosvold, 1991). To this end, organizations operate as interpretive systems (Burrell and Morgan, 1979; Daft and Weick, 1984) that develop capabilities to facilitate collective understanding and process a shared environment (Duncan, 1972; Weick, 1995). It can be challenging for organizations to maintain this essential cooperation and collective understanding due to individual self-interest (Barnard, 1938; Cyert and March, 1963). Bounded rationality complicates matters further since optimal decision making is not feasible (Simon, 1947). As a result, organizational actors cannot identify an objectively optimal solution, which opens the door for genuine conflict over alternatives and the appropriate goals to pursue.

Research shows that conflict exhibits nuanced effects on decision making outcomes and the individuals involved in the process as a function of the type of conflict experienced. Some forms of conflict operate to improve decision making, while other forms of conflict typically prove detrimental (Amason and Sapienza, 1995; Jehn, 1997; Jehn and Bendersky, 2003). Over the long term, detrimental forms of conflict can impair the aforementioned cooperative and interpretive function of the organization, which reduces the overall effectiveness of both the organization and its constituent members (Blake and Mouton, 1984; Korsgaard, Schwieger, and Sapienza, 1995; Jehn, Northcraft and Neale, 1999). Research in organizational conflict emphasizes two specific types of conflict that impact the decision making process differently: cognitive conflict and affective conflict (Pinkley, 1990; Jehn, 1995; Amason, 1996).

Cognitive conflict is “task oriented and arises from differences in judgments or perspectives” (Amason and Sapienza, 1997, p. 496). In general, this form of conflict improves decision making (Brehmer, 1976; Cosier and Rose, 1977; Priem and Price, 1991). It drives the exchange of information among individuals with different perspectives on factual or contextual factors that impact the decision (Mitroff, Mason and Barbara, 1982). Put another way, cognitive conflict triggers examination of a decision from varied perspectives, often facilitating broader consideration of issues and creative ideas about how to address the problem (Mason and Mitroff, 1981; Schwenk, 1990). In behavioral terms, it broadens search and this can often lead to better decision outcomes.

In contrast, affective conflict is emotional and personalized conflict between organizational members (Brehmer, 1976; Jehn, 1994; Amason, 1996). It highlights differences in values and creates (or reveals) personal animosity between individuals

(Jehn, 1995). Affective conflict is not focused on task requirements or the factual aspects of a particular decision. This type of conflict generally impairs decision making processes and hurts overall decision quality (Argyris, 1962; Amason and Sapienza, 1997; Jehn and Mannix, 2001). It can also generate distrust and outright hostility among organizational members (Walton and Dutton, 1969; Brehmer, 1976). At times, severe affective conflict leads some organizational members to sever relationships with the other parties to the conflict, and these individuals are either unwilling or unable to work together in the future (Ross, 1989; Korsgaard, Schwieger, and Sapienza, 1995). Thus cooperation and cohesion can substantially deteriorate within the organization due to affective conflict (Argyris, 1962; Baron, 1991; Amason, 1996). In light of this, individuals often develop affirmative strategies in which they avoid extremely negative interactions that are likely to produce affective conflict (Baron, 1988; Tsui, Ashford, St. Clair and Xin, 1995). Notably, conflict can also transition from cognitive to affective over time (Deutsch, 1969; Brehmer, 1976; Jehn and Mannix, 2001).

Satisficing impacts cognitive and affective conflict<sup>2</sup> within organizations in different ways. Satisficing creates boundaries on the extent of cognitive conflict that typically occurs. It focuses decision making around specific factors defined in terms of the problem at hand (March and Simon, 1958). In some instances additional cognitive conflict might improve decision making, but satisficing cuts off more extensive consideration (Simon, 1947). In contrast, affective conflict stems from personality

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<sup>2</sup> The focus here is on organizational misconduct. The discussion that follows examines the influence that organizational processes that manage affective conflict have in regard to organizational misconduct. However, satisficing is a general organizational conflict management technique. To the extent that other classes of decisions systematically generate affective conflict, a strategy of avoidance is also operative within organizations. A full examination of these additional applications within organizational decision making is beyond the scope of this work.

clashes and value differences that are largely irreconcilable (Brehmer, 1976; Jehn, 1991). This form of conflict is detrimental to the organization's continued ability to create value through cooperation (Voss, Cable and Voss, 2006). As a result, I argue that affective conflict is disfavored within organizations and that satisfied outcomes are necessarily structured to limit or avoid this type of confrontation.

The organizational need to limit affective conflict alters how individuals communicate within the decision process. The result is akin to what Rosen and Tesser (1972) deemed the "mum effect" in which individuals refuse to offer negative opinions if they fear that doing so will damage interpersonal relationships. This leads many organizations to develop norms about how decisions are discussed and framed (Nelson and Winter, 2002). Whenever possible, decisions consistent with shared values are favored and many organizations or groups exhibit norms that are "not accepting of open conflicts about relationship issues" (Jehn, 1997, p. 550). A process that highlights deep value inconsistencies is avoided whenever possible. Negative personal confrontations that cause affective conflict are disfavored and generally avoided (Tessler and Rosen, 1975). Criticisms and negative assessments are re-cast in indirect, value-neutral terms (Ploeger, Kelley, Bisel, 2011).

Decisions that carry ethical dimensions made within an organizational dynamic represent satisfied outcomes (Brady, 1990). However, individuals' ethical commitments are value-based (Schein, 1992). Conflict around these values is highly emotional, personal, and contentious (Rockeach, 1973; Locke, 1976). In this way, ethical conflicts carry an inherent risk of severe affective conflict. I argue that ethical confrontation therefore represents a uniquely disfavored form of conflict that creates special challenges

for organizations and their members. Quite simply, this type of conflict is too dangerous to be tolerated frequently. It is managed through limiting the examination of issues that would expose the true extent of the deep differences organizational members maintain (Simon, 1947; Cyert and March, 1963). Specifically, a norm of ethical conflict avoidance develops within organizational decision making processes. The strength of this norm is expected to vary across organizations. The norm also manifests itself through a reframing process where challenges to decisions with important ethical considerations are cast in impersonal or value neutral terms to “lower the personal and organizational costs of interpersonal conflict by confronting colleagues in nonthreatening ways” (Morrill, 1991, p. 872).

To be clear, a norm of ethical conflict avoidance does not imply that ethical confrontation *never* occurs within organizations. Rather, I assert that the stakes are quite high when it does and organizational actors recognize this is the case. As a result, they are often hesitant to confront other members of their organization on ethical grounds, even where warranted (Tessler and Rosen, 1975). This lowers the probability that discussion and confrontation will center on ethical dimensions within organizational decision making. Instead, ethical disagreements are more frequently couched in less value-sensitive terms through a reframing process. This limits an extremely hazardous form of conflict and facilitates cooperation within the organization (Jehn, 1995). However, it also submerges or fades ethical considerations from organizational decision making and foster an amoral process which increases the possibility of organizational misconduct (Tenbrunsel and Messick, 2004; Tenbrunsel and Smith-Crowe, 2008).

## 2.5 An Integrated Model of Organizational Misconduct

### *Overview*

The discussion that follows offers a formal model that connects individual decision making processes with organizational decision making processes to demonstrate how acts of misconduct can be initiated and proliferated within organizations.

Individuals employ a quasi-rational calculation to determine whether to intentionally initiate organizational misconduct (Simon, 1947; Becker, 1968). However, moral awareness also remains a critical consideration at the individual level (Rest, 1986). I adopt the arguments of March (1994) that individuals apply frames to decisions they face (Tenbrunsel and Messick, 1999). Where the ethical frame remains inactive, awareness does not result and individuals will at times initiate organizational misconduct unintentionally as well (Vaughan, 1999; Tenbrunsel and Smith-Crowe, 2008).

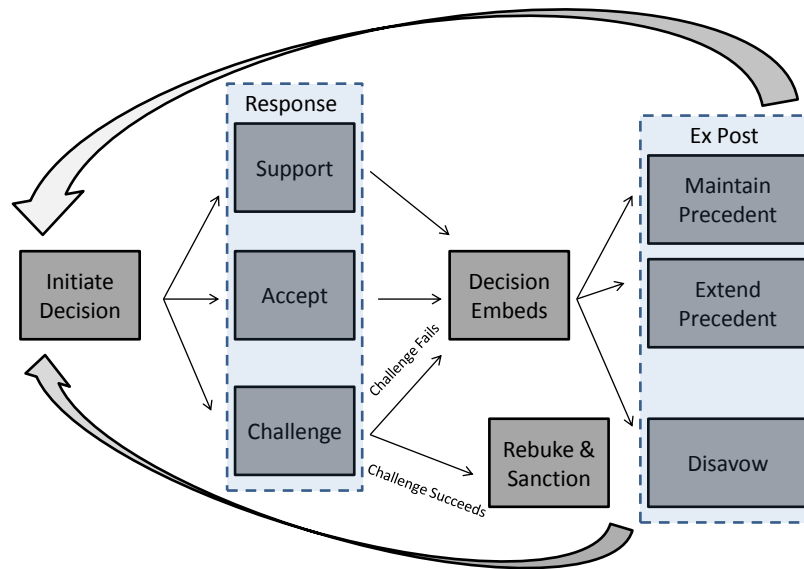
Additionally, organizational processes influence the potential for organizational misconduct both directly and through feedback into the individual processes highlighted above. Organizations are defined social systems and decision making within them is often very public (March and Simon, 1958). Decision makers know that their actions are observed and evaluated by others within the organization (Jehn, 1997). Observers face an independent decision about how to respond to the decisions of others. Both parties understand they are accountable to other organizational members for both the decisions they initiate and how they respond, which can alter decision making (Tetlock, 1985; 1989). The public nature of organizational decision making also highlights the need to manage conflict (Cyert and March, 1963). I argue that one means organizations use to manage conflict is an avoidance norm that provides that ethical conflict is generally

avoided or reframed. This norm exists to limit the levels of affective conflict within organizations which impair decision making quality and erode cooperation. However, the effects of avoidance feedback into the quasi-rational assessment individuals apply. Specifically a stronger avoidance norm can lead to a lower subjective assessment of the costs of misconduct and thereby facilitate more intentional bad acts. In addition, the avoidance norm leads both initiators and responders to favor ethically neutral frames for decisions and this fosters an amoral decision making process. The net result is that the probability of both intentional and unintentional organizational misconduct increases.

In addition, organizations also use precedents established through prior decisions as the basis for subsequent decisions (Boeker, 1997; Nelson and Winter, 1982). This is both an efficient means to enact decisions and also aids in the management of conflict (Cyert and March, 1963). However, the use of precedent can also impair the accessibility of an ethical frame because. This occurs because decision makers do not revisit the underlying rationale or logic of the prior decision (Pfeffer and Salancik, 1978). Instead the frame shifts to whether it is factually appropriate to apply the precedent to the case at hand (Hills and Mahoney, 1978). There is also a marked tendency within organizations to extend precedents to different contexts via a process of local search (Cyert and March, 1963; Allan, 1966). Even for extensions of a decision precedent, an ethical frame is inactive which facilitates an amoral decision process that increases the probability that organizational misconduct results.



Figure 2.1 - Organizational Misconduct Process Model



### *Organizational Misconduct: Decision Typology*

I specifically adopt Brief, et al. (2001) and Ashforth and Anand's (2003) position that misconduct occurs and spreads within organizations through four defined stages: initiation; proliferation; institutionalization; and socialization. Initiation involves an affirmative decision to engage in misconduct (Palmer, 2008). Misconduct can be initiated through both a quasi-rational analysis of costs and benefits that highlights ethical considerations or through an amoral process where awareness is not present (Vaughan, 1996; Palmer, 2008; Tenbrunsel and Smith-Crowe, 2008). It proliferates through social learning processes (Bandura, 1986), formal authority structures (Milgram, 1965; Palmer, 2008) and social comparisons (Cialdini, 2001). Over time, misconduct becomes institutionalized in organizational routines and structures which legitimize these actions as acceptable means to meet organizational ends (Simon, 1947; Walsh and Ungson, 1991; Oliver, 1997; Ashforth and Anand, 2003). Finally organizations develop socialization

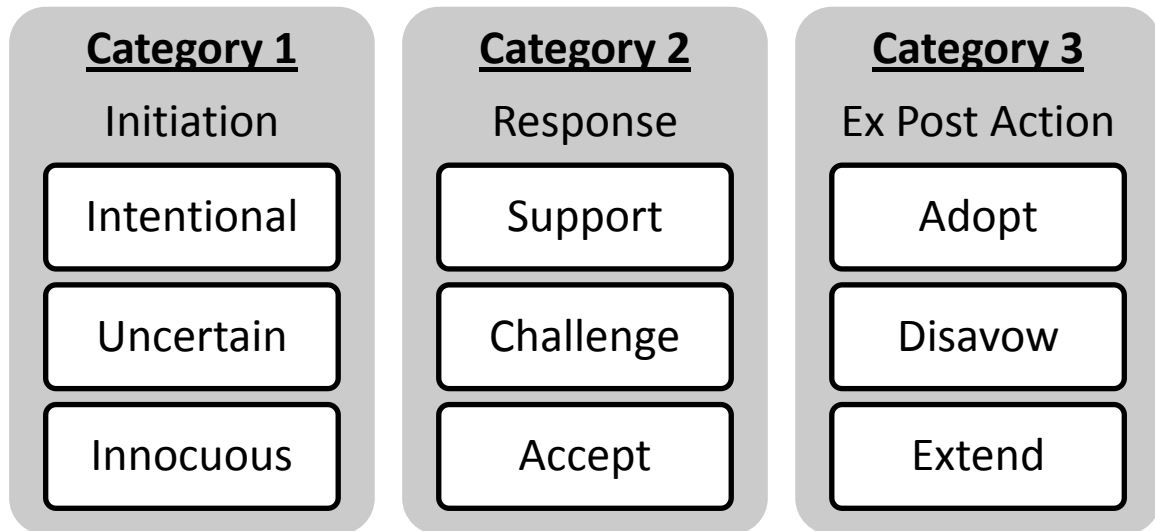
processes that indoctrinate new members with attitudes and beliefs that support misconduct (Mintzberg, 1978; Johns, 1999; Darley 2001; Ashforth and Asand, 2003; Palmer, 2008).

Initiation is obviously a key decision point. Figure 2.1 outlines an integrated process model that reflects both individual and organizational considerations that begins with initiation. Most organizations include at least a handful of individuals that will engage in misconduct if the perceived benefits outweigh the costs (Arrow, 1963; Hechter and Kanazawa, 1997; Finney and Lesieur, 1982). However, I also maintain that boundedly rational actors are aware of the potential for miscalculation and typically initiate misconduct only when the difference between costs and benefits they subjectively perceive is considerable. In addition, organizational misconduct often requires numerous members of the organization to act in concert (Greve, et al. 2010). Behavioral theory accounts for this concerted nature of organizational decision making through the idea of the dominant coalition (Cyert and March, 1963). I emphasize that individuals both within and outside this coalition observe decisions to initiate misconduct and fail to object. In this sense, both those that initiate and those that respond make affirmative decisions, but the decisions made are very different in nature. Therefore to better understand the process of organizational misconduct, there is value in treating these decisions as qualitatively distinct.

The decision typology I propose is set forth in Figure 2.2. Misconduct initiated in an organizational context typically represents a composite of distinct decision categories. First there are affirmative decisions to initiate a specific course of conduct. Second there are decisions to evaluate and respond to the planned actions of others. Finally, there is a

third category of decisions that arise as time passes referred to as ex-post actions. This latter category impacts proliferation and institutionalization of misconduct. Within the three categories, further distinctions are also relevant.

**FIGURE 2.2 TYPOLOGY OF ORGANIZATIONAL MISCONDUCT DECISIONS**



There are three initiation subcategories that are defined on the basis of knowledge and intent. Intentional decisions involve activities the decision maker is fully aware constitute an act of misconduct. Uncertain alternatives represent situations where it is unclear if an alternative is acceptable in ethical terms (Greve, et al., 2010). Uncertainty encompasses a broad spectrum of behaviors that range from relatively mild conduct that is most likely permissible to extremely questionable behavior. At the margins, uncertain behavior carries the substantial risk that a social control agent will deem the approach inappropriate (Palmer, 2008). Innocuous decisions involve actions that are clearly permissible when adopted. However innocuous decisions can stimulate misconduct ex-

post as they become precedents that are extended outside their original contexts (Allan, 1966; Mintzberg, 1978).

The second category of decisions that impact misconduct involves individuals' responses to the decision alternatives initiated by others. Decisions initiated within the organizational setting have an audience (Tetlock, 1985). Response decisions represent the reactions of observers to the logic, arguments, and actions others propose. A response decision requires no formal action on the part of the organizational actor beyond their participation in the decision making process. The response role is to evaluate the decision and the rationale supporting the approach. The potential for both cognitive and affective conflict exists in the interaction between decision makers that initiate action and those that respond.

Response decisions fall into the three subcategories of support, challenge, or acceptance. Supporters affirmatively communicate their agreement with a particular course of action. In contrast, the challenge subcategory represents those that voice opposition to the decision to adopt misconduct. Challenges can be based on a variety of rationales that include both ethical concerns and more value-neutral considerations. Challenge creates conflict within the organizational decision process (Jehn, 1995). In addition, individuals that elect to challenge often simultaneously propose an alternative course. In this way, organizational actors can oscillate between initiation and response roles within the decision making process. Acceptance represents the position of individuals that neither object nor voice active support for a course of action. Acceptance is very different from support (Barnard, 1938). Individuals that accept decisions often

maintain serious reservations about the approach. However, they fail to interject these concerns and permit the decision to move forward without challenge.

As time passes, individuals face a related decision of whether they will adopt, extend, or alter decisions that were previously made. While response involves fairly immediate reactions to decisions, the ex-post category involves a decision's role and influence within the organization's institutional memory (March and Levinthal, 1981). In this regard, organizations rely substantially on prior decisions as the basis for subsequent decision making and the adoption of precedent is one type of ex-post decision (Cyert and March, 1963). Precedents are often extended to somewhat different circumstances ex-post (Allan, 1966). This represents the second subcategory, extension. Finally, changed circumstances or adverse feedback can cause organizations to abandon precedents and approach a decision anew (Levinthal and March, 1993; Baum and Dahlin, 2007).

#### *Initiation & Response*

Initiation and response decisions reflect the social reality of organizational decision making. Decisions are initiated with an audience (Tetlock, 1985). The presence of this audience alters the way individuals within organizations behave in subtle ways (Ashford and Cummings, 1983). Individuals that initiate action select from various decision alternatives with the knowledge that multiple actors across the organization will evaluate their choice (Tetlock, 1989). Organizational decisions carry political consequences and those that initiate action are accountable for their choices (Cyert and March, 1963; Tetlock, 1985). In this way the organization and its constituent members represent relevant social control agents (Greve, et al., 2010). Initiators face the risk that others within the organization will assess their decision negatively and that sanctions will

follow (Stigler, 1970; Warren and Smith-Crowe, 2008). Those that initiate consider the extent that their actions are observable, and the likelihood that others will object to the behavior and create conflict as they make decisions (Braithwaite and Makkai, 1991).

Thus the response that initiators expect influences their initial choice (Arrow, 1963; Becker, 1968). Those presented with a response decision face a different type of choice, but one for which they too are accountable (Tetlock, 1989). In this way, the social nature of organizational decision making alters all “actors’ subjective probabilities of disapproval and subsequent loss” which in turn creates “impression management motives” (Ashford and Northcraft, 1992, p. 314; Arkin, 1981). Impression management should decrease the motivation to initiate organizational misconduct for many individuals. However, impression management considerations can also inhibit the probability of a challenge couched in ethical terms. This is the case because the decision to challenge a colleague’s decision on ethical grounds carries the potential to be viewed negatively by others within the organizational audience (Greenberger, Miceli and Cohen, 1987; Trevino and Victor, 1992). It will generate destructive conflict that is disfavored within the organizational decision making process (Schein, 1992; Jehn, 1994). Those that violate the avoidance norm and challenge decisions on ethical grounds also risk censure and ethical challenges grow less likely as a result. Instead, individuals structure responses that “construct acceptable accounts” from the perspective of the audience to avoid “varying degrees of censure” (Tetlock, 1985, p. 307). Challenges that do occur tend to be reframed in ethically neutral terms which fosters an amoral decision making process at the organizational level (Tenbrunsel and Smith-Crowe, 2008).

The collective nature of organizational decision making implies that significant diversity of knowledge and intent can exist across initiators and responders (see Figure 2.3).<sup>3</sup> Some decisions clearly violate existing standards and this is known by everyone involved in the process (Palmer, 2008). On other occasions, uncertainty exists for the initiating decision maker, the responding decision maker, or both of these parties (Vaughan, 1999; Greve, et al., 2010). The level of uncertainty within the decision process across the distinct roles of initiation and response also presents some important considerations in organizational decision making with ethical implications.

**FIGURE 2.3 Misconduct Knowledge Matrix**

	Knowing	Uncertain	Mixed
Initiation	A	B	C
Response	D	E	F

#### *Knowing & Intentional Misconduct*

Some intentionally bad actors are present within most organizations and “much organizational misconduct begins with the actions of one or a small number of individuals” (Greve, et al., 2010, p. 57). Sound hiring practices, robust monitoring processes, appropriate incentive arrangements, and strong ethical culture operate to limit and control bad actors within organizations to some extent (CITE). However, it is

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<sup>3</sup> Given the complexity of organizational decision making, the mixed category is clearly a common decision context. To simplify the analysis, I will focus the discussion on situations where at least one person has knowledge or where all parties to the decision lack knowledge.

impossible for organizations to completely eliminate the risks bad actors pose (Stigler, 1970). Thus some level of intentional misconduct is expected to be initiated in all organizations. Under a boundedly rational decision process, intentional bad actors apply an imperfect but intendedly rational calculation to situations to determine whether they will initiate misconduct (Becker, 1968). Intentional initiators make a rough approximation of the benefits they expect and the likelihood that they will get caught and misconduct results if the difference between these cost and benefits is sufficiently large (Hechter and Kanazawa, 1997).

The potential for challenge and sanction within the organizational decision process clearly impacts the initiator's assessment. The avoidance norm provides that individuals faced with a response decision are generally hesitant to challenge others' organizational decisions on ethical grounds. This remains the case even where intentionally bad acts are contemplated and those that respond are aware of the wrongful nature of the acts (the A/D-Condition in Figure 2.3). This response, where anticipated, reduces an initiator's perceived costs of intentional misconduct (Szwajkowski, 1985). This influences the quasi-rational decision calculus decision makers apply and increases the potential that misconduct is initiated. Initiation can grow less calculated and more mindless as the expectation of discovery and sanction drops through the absence of negative feedback associated with bad acts over time (Cialdini, 2001; Palmer, 2008).

Notably, the avoidance norm does not inhibit individuals from challenging decisions on grounds other than ethical considerations and this reframing process is likely to occur (Ploeger, Kelley, and Bisel, 2011). When members of the decision audience know the decision is ethically inappropriate, I maintain reframing is most likely to occur.



However this approach is less effective than a direct ethical challenge for two related reasons. First, framing challenges in factual or business terms can legitimize the proposed course (Baum and Oliver, 1991; Suchman, 1995; Deephouse, 1996). Put another way, the failure to label an act of misconduct as misconduct frames the discussion as a business decision and makes the alternative a legitimate option if the business case supports it (March, 1994). The underlying decision premise (Simon, 1947) becomes that the organization ought to adopt this approach if it makes sound business sense. The objectionable character of the act is lost and an amoral process results (Tenbrunsel and Messick, 1999; Tenbrunsel and Smith-Crowe, 2008).

The related problem with reframing in ethically-neutral terms is that a very strong business case for misconduct may exist. For example, if one removes ethical considerations, sweatshops offer a compelling business opportunity tied to reduced costs. Elimination of the ethical dimensions of decisions also operates to remove the costs of potential sanctions for misconduct from any cost-benefit analysis tied to the decision. In this way, a challenge framed in business terms represents a weaker counter-argument compared to the characterization of the action as misconduct. Reframing causes the ethical dimensions of the decision to fade and this can facilitate organizational misconduct (Tenbrunsel and Messick, 2004).

Finally, the support response bears special consideration. Those that support intentional misconduct may create a chilling effect on ethical challenge and strongly reinforce the avoidance norm. This is the case because those with reservations about the decision face a situation where they will trigger affective conflict with multiple organizational actors if they raise their concerns after support is expressed. For those that

initiate intentional misconduct, support also operates as a signal (Spence, 1973).

Supporters represent potential recruits for future coalitions that advocate unethical or aggressive behavior (Palmer, 2008). Support can also trigger reciprocity norms and lead initiators to reciprocate support for later acts of misconduct advocated by the supporter of this initial decision (Cialdini, 2001).

### *Uncertainty*

In general, decision makers select a particular alternative on the basis of the consequences they expect (March, 1994). Most decisions, however, retain significant uncertainty and the full consequences of a decision are neither known nor knowable a priori (Simon, 1947; Cyert and March, 1963). In this regard, organizational decision makers often encounter considerable uncertainty as to whether specific actions violate norms or rules as defined by relevant social control agents (Edelman, 1990; Palmer, 2008). Uncertainty, in this case, goes well beyond a mistaken assessment by bad actors of the potential that they will get caught. Good intentioned decision makers often face uncertainty about facts or the acceptable standard of conduct which can lead them to commit unintentional acts of misconduct (Vaughan, 1996; 1999; Greve, et al., 2010).

Decision makers that initiate, those that respond, or both initiating and responding decision makers can face uncertainty (Conditions B/D, A/E and B/E respectively). When uncertainty is present, the norm of ethical conflict avoidance maintains its dampening effect upon ethical discourse. However, ceteris paribus I expect the avoidance norm to be more powerful when responders are uncertain. This is the case because the appropriateness of the ethical challenge grows more ambiguous. As a result, uncertain individuals give colleagues the benefit of the doubt and grow less likely to challenge

decisions on ethical grounds relative to situations where uncertainty is not present. In this way, uncertainty enables ethically marginal decisions to move forward without an appropriate consideration of the ethical implications of the decision. This again facilitates an amoral decision process that increases the possibility of organizational misconduct (Tenbrunsel and Smith-Crowe, 2008).

Additionally, decision makers that initiate misconduct at times are unaware of the wrongful nature of their approach, but those that respond to the proposed action do have the necessary awareness (the B/D Condition). The norm of ethical conflict avoidance is particularly problematic here. In this decision context, decision makers that evaluate and respond remain unlikely to challenge the decision in ethical terms. However, the actors that propose the inappropriate alternative lack any intent to engage in misconduct. A substantial probability exists that if these organizational actors were made aware of the ethical dimensions of their decision, they would select a different alternative. This awareness exists for others within the organization, but fails to surface within the actual process of decision making due to concerns about the debilitating effects of affective conflict. The avoidance norm silences ethical discourse, an ethical frame for the decision remains dormant, and poor choices can follow.

### *Organizational Search*

Under behavioral theory, stability and uncertainty reduction are general goals of all organizations (Simon, 1947; March and Simon, 1958). In uncertain contexts, behavior often results as an outcome of sequential problemistic search that is local in nature (Cyert and March, 1963). Problemistic search involves “search that is stimulated by a problem (usually a rather specific one) and is directed toward finding a solution to that problem”

(Cyert and March, 1963, p. 121). Significantly, the solutions identified and adopted typically draw heavily upon previous approaches the organization has employed to solve similar issues (March and Simon, 1958; Cyert and March, 1963). In this way, search becomes motivated, simple-minded, and biased. Simple-minded search looks for alternatives “in the neighborhood of the problem symptom” and “the neighborhood of the current alternative” (March and Simon, 1958, p.121). Search also grows biased based upon the specialized knowledge or prior experience of parts of the organization, as well as “communication biases reflecting unresolved conflict within the organization” (Cyert and March, 1963, p. 122). In this way, search is biased to view problems in terms the organization perceives it is best able to solve them. Specifically, organizations grow to emphasize how similar problems were resolved in the past and the specialized knowledge and skills the organization has cultivated to solve the problems they encounter.

#### *The Power of Precedent*

The adoption of precedent is a means of ex-post decision making that plays an important role in the organizational decision making process (Mintzberg, 1978). A precedent is a plan that “defines decisions” and provides “a prima facie case for continuing existing decisions” (Cyert and March, 1963, p. 111-112). Rules represent “formalized prescriptions and proscriptions about appropriate actions” (Lehman and Ramanujam, 2009, p. 644; March, 1997). Thus rules can be thought of as formalized and binding precedents. However, precedents also include informal standards or norms that develop which influence appropriate actions (Feldman, 1984). For my purposes, any prior decision creates a precedent that decision makers can utilize to guide future action. As noted above, problemistic local search creates a bias for organizations to rely upon a

defined set of solutions to the problems (Cyert and March, 1963). In this manner, organizations rely extensively on existing decision precedent to make subsequent decisions (Allan, 1966).

Precedents are attractive because they ease decision maker's cognitive load and enable coordination. Precedents constitute a source of authority within organizations (Simon, 1947; Lehman and Ramanujam, 2009). They permit individuals to substitute another's judgment for their own which eliminates the need to examine the full scope of the problem or the merits of various alternatives (Barnard, 1938; Simon, 1947). In this way, precedents provide a well defined and highly salient alternative within an organizational decision making process that is both time and attention constrained (Chung, Bazerman and Banaji, 2005). Precedents also help boundedly rational actors coordinate the localized decisions that result across complex organizations. They offer clear guidance on the expected standard of behavior within the organization (Weber, 1947). This makes decisions making more predictable (Devetag, 2005). Through enhanced predictability, precedents enable more complex organizational design and permit the diffusion of decision making authority to lower levels of an organization (Chandler, 1962; Pugh, et al., 1972).

Most significant to the process model outlined here, precedents are also extremely attractive because they reduce the conflict inherent within organizational life (Cyert and March, 1963). Adoption of a precedent effectively avoids making a decision anew and allows decision makers to focus their attention solely on the extent to which the precedent applies (Pfeffer and Salancik, 1978; Hills and Mahoney, 1978). Decision makers do not revisit the content of the decision itself and this eliminates the need to resurface latent

conflict. The fact that the precedent exists indicates it is minimally acceptable across the varied interests within the organization (Simon, 1947). Due to these advantages, precedents come to drive a considerable amount of organizational decision making and action over time (Boeker, 1997; Nelson and Winter, 1982).

The adoption of precedents within organizational decision making is highly relevant to misconduct, specifically the availability of an ethical decision frame (Tenbrunsel and Messick, 1999; Tenbrunsel and Smith-Crowe, 2008). Ethical frames are activated within organizational decision making more frequently the first time an organization faces a decision (Davies and Crane, 2003). This is the case because novel issues permit and encourage decision makers to examine broader facets of a problem (Cyert and March, 1963). In contrast, where a precedent exists, the analysis shifts to the much more limited determination of whether to adopt this preexisting approach. The underlying content of the decision is no longer the subject of the inquiry (Pfeffer and Salancik, 1974). This occurs for the same reasons that precedents are attractive generally: cognitive efficiency, coordination benefits, and most significantly, conflict avoidance. However, the adoption of precedents for decisions that carry ethical dimensions is more probable due to the organizational need to manage the dangerous forms of conflict ethical challenges can generate (Jehn, 1995). In this way, the use of precedent within organizational decision making independently impairs ethical awareness and also fosters an amoral process (Tenbrunsel and Smith-Crowe, 2008).

This role precedents play makes even a single unintentional act of misconduct extremely dangerous from an organizational perspective. Organizations (and the individuals within them) learn over time and develop memories (March and Simon, 1958;

Walsh and Ungson, 1991). Goals, attention rules, and search rules are adapted based upon experience (March, 1994). Successful search strategies are not altered and the focus remains on very short-term feedback (Levinthal and March, 1981). Thus decisions that receive adequate short term feedback are powerful organizational heuristics for future decisions. Given this, any decision could potentially form a powerful precedent and this includes acts of misconduct.

But even initially innocuous decisions carry the potential to trigger organizational misconduct over time. This is the case because precedents serve as a meaningful jumping-off point in the search for an appropriate solution even for more novel issues. As a result, precedents are often extended to other contexts deemed sufficiently similar through the process of local search (Cyert and March, 1963; Allan, 1966). Where a precedent has generated satisfactory feedback, it may be extended to cover a wider set of organizational problems encountered in the future. Even with experienced decision makers, the extension of a precedent may emphasize or discount certain factors incorrectly (Allan, 1966). Under these conditions, the loss of the ethical frame can grow acutely problematic. Mistaken application of the precedent to inappropriate contexts can lead to additional acts of unintentional misconduct (Vaughan, 1999). Furthermore, each subsequent extension of a precedent also carries precedential value and can serve as a new point of search departure for a subsequent issue. Incremental extensions of this sort can lead organizations to adopt decisions that would be inconceivable if the full consequences were presented at the initial decision in the chain (Mintzberg, 1978).

## 2.6 Discussion

In their discussion of search biases Cyert and March (1963) “assume that communication bias can be substantially ignored in our models except where the internal biases in the firm are all (or substantially all) are in the same direction or where biases in one direction are located in parts of the organization with an extremely favorable balance of power” (p.122). The argument developed here is that ethical disagreement represents an important area where such communication bias results. The avoidance norm and the tendency to reframe challenges represent communication biases that limit the exchange of information that occurs within organizations. This can impair the quality of the decision process and lead to the poor organizational outcome of misconduct.

Additionally, a fairly consistent finding within the literature is that those who report ethical violations are generally disliked by others in the organization (Trevino and Victor, 1992). This is the case even where a challenge is appropriate and justified. Whether individuals like or dislike someone impacts their willingness to cooperate with that person in the future (Cialdini, 2001). In this fashion, individuals that violate the avoidance norm impair their effectiveness within the organization. This negative reaction makes the avoidance norm both highly salient and very powerful within many organizational settings.

Further, intentionally bad actors often do not view themselves as corrupt (Sykes and Matza, 1957; Ashforth and Anand, 2003; Bazerman and Moore, 2008). These individuals develop self-serving rationalizations that enable them to maintain a positive self-identity and reduce dissonance (Coleman, 1998; Greenberg, 1998; Palmer, 2010). The avoidance norm can also enable this positive image conservation. The lack of any



confrontation provides a ready-made rationalization: it represents social proof that the actions in question are acceptable within the organization (Bandura, 1999; Cialdini, 2001). In this manner, peers' failures to challenge decisions to engage in misconduct helps bad actors maintain a non-criminal or positive self-image despite their actions.

There are ways that organizations can improve ethical conflict management and limit the impact of the avoidance norm. First, organizations can cultivate constructive confrontation norms that facilitate the effective management of all forms of conflict (Jelinek and Schoonhoven, 1990; Kellermans, Floyd, Pearson and Spencer, 2008). Constructive confrontation norms foster conditions that make conflict more acceptable. These norms emphasize that the process of conflict management is a cooperative task in its own right. Constructive norms are not easy to develop. However ethical discourse and the moral dimensions of decisions are exceedingly important aspects of problems and need to be considered if decision making is to remain effective over the long run.

Furthermore moral development is enhanced when individuals engage in moral decision making provided "these discussions arouse cognitive conflict among the participants" (Trevino, 1986, p. 607). The difficulty highlighted here is that ethical conflict is more likely to generate affective conflict which leads to the avoidance of these dimensions of a problem (Schein, 1992; Jehn, 1997). In light of this, ethical discourse that occurs through training programs takes on added significance. These programs offer a safer environment to engage in ethical conflict. They permit individuals to discuss ethical problems in abstract or hypothetical terms and encourage dissent in regard to an appropriate course. Such training should emphasize techniques tailored to address ethical conflict within the organizational setting and foster positive norms.

The integrated model developed here draws extensively from prior process models developed by Brief, et al. (2001), Ashforth and Anand (2003), and Palmer (2008). As an initial point, these earlier models focus on the collective nature of wrongdoing, largely confining their analysis “to the group level” (Ashforth and Anand, 2003, p. 3; Palmer, 2008). Here, I begin to develop how individual and organizational processes interact to facilitate organizational misconduct generally. In particular, I discuss how organizational processes feedback onto an individual’s decision process in ways that can alter the individual’s subjective assessment of the decision to engage in misconduct. This highlights how organizational decision processes influence both collective and individual decisions to initiate misconduct. In addition, other key contributions of the process model extension set forth here include the discussion of the impact that the avoidance norm has on ethical discourse within organizational decision making, the development of the issues that accountability create for all those involved in the decision making process, and the examination of the role that precedent plays in facilitating misconduct.

In regard to the avoidance norm, existing process models recognize that organizational structures and the formal patterns of communication can lead to misconduct. Specifically, the division of labor and communication patterns “shape the amount and type of information organizational participants have at their disposal when making decisions” (Palmer, 2008, p. 119). I incorporate an additional rationale based on behavioral theory premises that demonstrates how organizational communication can become biased in a way that facilitates misconduct. Organizations and their constituent members seek to manage deleterious forms of conflict (Cyert and March, 1963; Jehn, 1995). The need to contain affective conflict often motivates individuals to place ethical

confrontation off limits within organizational decision making. This creates a significant communication bias that eliminates awareness of the ethical dimensions of many decisions. Loss of awareness can stimulate both intentional and unintentional forms of misconduct. The avoidance norm operates in distinct (and broader) ways relative to the influences previously emphasized in the literature such as formal communication and authority structures, or the division of labor.

Additionally, prior process models of misconduct stress the effect social influence mechanisms can have on initiation and proliferation. The specific influence mechanisms highlighted include formal authority, commitment, reciprocity, social proof and liking (Palmer, 2008). As Tetlock (1985) notes, accountability is a critical concern within organizational decision making. The extension I develop emphasizes the idea that accountability coupled with the need to maintain cooperation within organizations can also dramatically influence initiation and proliferation. Organizational actors are required to structure defensible accounts for their actions. The fact that ethical confrontation is disfavored within organizational decision making creates meaningful accountability issues for those that surface these types of issues. This goes beyond simply disliking individuals that raise ethical concerns. Those that pose ethical challenges risk being viewed as problem actors who resorts to personal attacks on colleagues. They may compromise their effectiveness within the organization because other actors will discount their opinions or avoid working with them in the future.

Further, precedents are prior decisions that potentially play a significant role in future decision making. Ashforth and Anand (2003) specifically observe that unethical decisions can serve as precedents that come to be relied upon extensively within

organizational decision making. This allows acts of misconduct to institutionalize and become “stable, repetitive, and enduring activities that are enacted by multiple organization members without significant thought about the propriety, utility, or nature of the behavior” (Ashforth and Anand, 2003, p. 4; Zucker, 1977; Greenwood & Hinings, 1988). An important point I raise in relation to precedent’s influence on organizational misconduct is that precedents are attractive because they reduce conflict. In this regard, decisions that enter an organization’s memory become not only *legitimate* (Greve, et al., 2010; Palmer, 2008) but *preferred* as a means to manage conflict (Cyert and March, 1963). Furthermore, my analysis adds to the existing process literature by highlighting how the extension of precedent can be problematic. Specifically, the precedent-setting decision does not need to represent an act of misconduct to cause significant problems in the future. Extensions of innocuous decision to different contexts can lead to unintentional acts of misconduct over time as well.

Prior process models of organizational misconduct also emphasize that the formal authority structure of the organization and social learning or association can ingrain a culture of misconduct within an organization (Sutherland, 1939; Brief, et al, 2001; Ashforth and Anand, 2003; Palmer, 2008). However, debate exists as to whether widespread misconduct must be initiated by the senior leadership (see Brief, et al., 2001 and Ashforth and Anand, 2003) or whether it can originate at lower levels of the organization as Palmer (2008) argues. I maintain that organizations’ reliance upon local rationality enables misconduct to begin at all levels of the organization. As a result, consistent with Palmer, I argue that initiation is not driven exclusively by senior managers through lines of formal authority. All that is required is that a particular

individual retain authority over a decision with misconduct as an option (Bromiley and Harris, 2007).

Local rationality takes on further significance in conjunction with the idea that organizations have memories and develop repertoires of response tied to prior actions (Levinthal and March, 1981). Any choice that enters the organization's decision history is available for others to follow on subsequent occasions (Cyert and March, 1963; Allan, 1966; Pfeffer and Salancik, 1974). In this way, precedents become a form of impersonal authority and a means of impersonal social learning within organizations (Simon, 1947; Lehman and Ramanujam, 2009). They allow decision makers to apply and justify their actions in relation to the prior decision based solely on knowledge of the outcome. Decision makers do not require any direct social contact with the individuals or groups that arrived at the precedent setting decision.

On a final note, the fact that misconduct results from individuals that follow good-intentioned precedents and lack any intent to behave improperly is very troubling. Complex organizations often rely on bureaucratic structure (Weber, 1947). The development of precedents and decision rules is in many situations essential to effective organization and management (Cyert and March, 1963). However, in light of the risks, I argue that organizations must affirmatively limit the precedential value of decisions that carry significant ethical considerations. These decisions must be carefully and critically considered every time, with decision makers free to draw upon an ethical frame to evaluate the appropriate course of action. In particular, managers must grow sensitive to the concerns associated with the extension of precedents. Eliminating the precedential value of ethically charged decisions means that individuals within organizations must

face these value-laden decisions more frequently. As a result, they must develop the skills necessary to manage the conflict that these types of issues can create.

## **2.7 Conclusion**

The literature on organizational misconduct has recognized that both individual and organizational processes impact misconduct but theories that offer insight into how these processes interact are needed (Greve, et al., 2010). Here I theorize how individual decision processes relate to organizational decision making processes in ways that increase the probability of organizational misconduct. Individuals invoke a quasi-rational process and frame their decisions (Cyert and March, 1963; March, 1994). Moral awareness is also a critical component of individual decision making where ethical dimensions are present (Rest, 1986; Tenbrunsel and Smith-Crowe, 2008). Some individuals will intentionally initiate misconduct where the benefits to this behavior substantially outweigh the costs (Becker, 1968). Others will lack this intent but mistakenly assess or fail to recognize the ethical dimensions of a decision (Vaughan, 1999). In light of this, specific factors that alter the subjective cost-benefit assessment or effect the development of moral awareness will impact the incidence of organizational misconduct.

Organizational decision making processes represent an important factor that can both alter the decision calculus and impair ethical awareness. Specifically, conflict management processes within organizational decision making can create an environment that facilitates organizational misconduct. In this regard, a norm of ethical conflict avoidance and the extensive use of decision precedents operate to reduce ethical

awareness within organizational decision making. In this regard, organizational members recognize that conflict is a feature of organizational life that must be managed to maintain cooperation and coordination (Cyert and March, 1963). In particular, affective conflict must be limited. Conflict that stems from ethical disputes generates significant amounts of affective conflict (Schein, 1992). As a result, organizations develop a norm of ethical conflict avoidance in decision making. Avoidance takes the form of a willingness to allow decisions or actions to go unchallenged despite serious reservations about the ethical implications on the part of many involved in the decision making process (Tessler and Rosen, 1975). Instead challenges are often reframed to characterize problems as factual or business criticisms (Morrill, 1991). The avoidance norm can operate to reduce the subjective costs individual decision makers identify which can increase the probability of intentional misconduct. In addition the norm and reframing process fade the ethical dimensions from problems which can impair awareness and make unintentional misconduct more likely as well (Tenbrunsel and Smith-Crowe, 2008).

In addition, organizations manage conflict and facilitate coordination through the use of decision precedents. Organizations often engage in problemistic search that is simple-minded and local in nature (Cyert and March, 1963). Precedents that were used previously for similar issues represent attractive alternatives. However, reliance on precedent causes organizational decision makers to frame the decision in factual terms with decision analysis limited to the analysis of whether the precedent fits the new context (Pfeffer and Salancik, 1978). The underlying content of the decision is not examined and the risk becomes that ethical considerations fail to surface (Davies and Crane, 2003). The use of precedent can grow increasingly problematic in regard to

decisions with ethical dimensions as precedents are extended to more novel situations (Allan, 1966). The net result is that organizational decision making facilitates amoral decision processes (Tenbrunsel and Smith-Crowe, 2008). This decreases moral awareness in organizational decision making and increases the probability of organizational misconduct as a result.

As a final note, it is important to stress that behavioral theory and the extension to ethical decision making set forth here are descriptive rather than normative theories of decision making. They are firmly rooted in the practical and pragmatic, as opposed to the ideal. Sutherland (1983) took the rather discouraging position that organizations are naturally criminogenic. I argue here that organizational decision making processes can increase the probability of misconduct. However, one must consider that organizations make a vast number of decisions every day. These decisions are largely effective and in no way facilitate misconduct. In this regard, the problems organizational decision making processes create are akin to the issues that decision heuristics create for individuals (Cialdini, 2001). These processes are essential and enable actors to function in an otherwise overwhelming environment, even though they sometimes lead decision makers astray. The problems identified here are not intended as a wholesale critique of organizational decision making. The challenge organizational actors, researchers, and management educators face is to improve our understanding of these problems and develop ideas about how to improve the situation in light of the clear value organizational decision making processes provide. The reality is that organizations need to limit conflict to function (Cyert and March, 1963). Organizations also need to be able to rely on prior decisions to guide future behavior. The key is to find better ways to surface ethical



conflict and continue to examine the precedents an organization develops. While organizational misconduct cannot be eliminated, it can be reduced through better sensitivity to the influence organizational conflict management processes wield.

## **CHAPTER 3 - EXPERTISE, STATUS & ORGANIZATIONAL MISCONDUCT**

### **3.1 Overview**

The avoidance norm and the use of decision precedents can influence individual decisions to initiate organizational misconduct. Other individual and organizational factors in turn influence the potential strength of the norm within a specific decision context, along with the likelihood that a particular decision becomes relied upon as a precedent to guide subsequent action. Here the characteristics of expertise and status are examined as they relate to the decision to initiate organizational misconduct. The expectation is that these two characteristics will exhibit a positive association with the incidence of misconduct within organizations.

Both expertise and status carry the potential to influence the subjective assessment of costs individuals apply to determine if they will initiate misconduct. Specifically, experts and high status actors are difficult to monitor and challenge (Podolny, 1994; von Nordenflycht, 2008). This can lower these decision makers' subjective assessments of costs and increase the potential for misconduct. In addition, I anticipate that increased levels of both expertise and status will enhance the power of the avoidance norm. This is the case because of the prominent accountability issues one faces when challenging the decision or advice of expert or high status actors (Tetlock, 1985). In addition, expert and high status actors' decisions are more likely to be utilized as precedents (CITE). Moral awareness remains an issue when organizations rely on precedents. As a result, expertise and high status are expected to exhibit a positive association with organizational misconduct.

The remainder of this chapter proceeds as follows. First, the concepts of expertise and status are developed in relation to the existing literature. Next the manner in which these attributes impact organizational decision making is discussed. Then the implications of expertise and high status have on the probability of organizational misconduct are developed. As noted above, both expertise and status are expected to have a positive impact on the probability of organizational misconduct. Finally, the implications of the arguments set forth in the chapter are discussed.

### **3.2 Expertise**

#### *An Expert Defined*

The study of experts is most developed within research on cognitive psychology and the decision making literature. An expert is defined as someone “displaying special skill or knowledge derived from training or experience” (Shanteau and Stewart, 1992, p. 95, citing Webster, 1979). Expert is a relative term that compares individuals with greater knowledge and skill in a specific domain to those that lack these qualities (Littlepage and Mueller, 1997; Snizek, Schrah and Dalal, 2004). An expert “knows a great many things” and can “rapidly evoke the particular items relevant to the problem at hand” (Larkin, McDermott, Simon and Simon, 1980, p. 1336). Expertise is developed in three stages: the cognitive stage where relevant information is acquired and memorized; the associative stage where the connections across domain elements deepens; and the autonomous stage in which skills are practiced at a high speed (Fitts and Polson, 1967). Experience and deliberate practice of fundamental skills are essential to the development of expertise (Newell and Simon, 1972; Ericsson, Krampe and Tesch-Romer, 1993).

Experts can be identified based upon their knowledge and thought process. Expertise involves the acquisition and use of large amounts of domain specific knowledge (Wiley, 1998). However experts also think about problems within their domain differently than non-experts (Ericsson and Charness, 1994; Sternberg, 1997). They structure domain knowledge in ways that make this knowledge more integrated and accessible (Ericsson and Staszewski, 1989). Experts also grow adept at rapidly recognizing patterns or chunks of relevant information (Simon, 1987). They develop more abstract models of domain problems which permits them to adopt more holistic and efficient solutions (Shanteau, 1992).

An alternative means to define expertise involves the quality of the outcomes an expert generates. This approach emphasizes whether the expert applies their skills and knowledge more effectively than novices (de Groot, 1946). The clear expectation is that experts produce and reproduce better outcomes on demand along representative tasks within a domain (Chase and Simon, 1973; Ericsson and Smith, 1991; Ericsson and Lehmann, 1996). Experts' judgments should also display internal and external consistency (Einhorn, 1974; Shanteau, 1995). However, the empirical evidence on experts' ability to generate better outcomes consistently is somewhat mixed (Phelps & Shanteau, 1978; Chan, 1982; Shanteau, 1992; Stewart, Heideman, Moninger and Reagan-Cirincione, 1992). Generally, experts outperform novices where judgments or tasks rely upon objective factors (Shanteau, 1992). The advantages of expertise are also limited to problems typically encountered within the expert's domain and novices can often outperform experts when tasks are extremely novel or outside this domain (Chase and Simon, 1973; Voss, Vessonder and Spilich, 1980).

Experts, like most individuals, remain subject to the influence of decision making heuristics (Tversky and Kahneman, 1974). They often rely on a limited number of decision cues, despite the availability of rich information (Einhorn, 1974; Ebbesen and Konecni, 1975). As a result, in many contexts expert performance can be replicated by a linear model that combines a limited number of predictors (Dawes and Corrigan, 1974). Interestingly, domain-specific heuristics often facilitate expert performance (Simon, 1987). For example, experts often exhibit better perceptual abilities that lead to “accurate anticipation based on advance perceptual cues” (Ericsson and Lehman, 1996, p. 292).

### *Organizational Expertise*

Expertise is a characteristic of both individuals and the organization itself (Starbuck, 1992). Organizational expertise is the ability of the organization to deliver greater value to its stakeholders through the use of its specialized knowledge and capabilities (Faraj and Sproull, 2000). It entails “consciously accumulated, specialized skills that represent mastery of a particular organizational process” (Bingham, Eisenhardt and Davis, 2007, p. 32). Organizations generate value through their patterns of interaction among diverse organizational members (Brown and Duguid, 1991). They are systems where structures, accumulated knowledge, and skills unlock this value. Organizations “provide the physical, social, and resource allocation structure so that knowledge can be shaped into competences” (Teece, 1998, p. 62).

Expertise often forms the basis of competitive advantage and allows organizations to outperform their less skilled rivals (Wernerfelt, 1984; Barney, 1991). Translating expertise into superior organizational performance is not easy. It is contingent upon the organization’s ability to transfer and utilize specialized knowledge across the

organization (Argote and Ingram, 2000). Knowledge transfer of this type presents some challenges for a number of reasons. First, expertise has a number of tacit characteristics (Hinds, Patterson and Pfeffer, 2001). Tacit knowledge is more difficult to transfer compared to knowledge that is more codifiable (Winter, 1987; Polanyi, 1966). Second, some forms of expertise require applied experience to fully realize their value (Teece, 1982). Those that lack this experience will be unable to use the knowledge appropriately. Finally, the absorptive capacity of the transferee also impacts the potential to derive value from knowledge transfers (Cohen and Levinthal, 1990). Thus, it can prove difficult for non-experts to both effectively evaluate and utilize the expertise available to them (Zardkoohi, Bierman, Panina, and Chakrabarty, 2010). Trust therefore becomes a vital component in the transfer and use of expertise by novices (Walton, 1975; Szulanski, 1996). Ultimately, expertise is extremely valuable but its value can be frustrated through problems with knowledge transfer. Interestingly, these issues are not solely a problem for the non-expert. Experts may also struggle to communicate the value they provide to non-experts (von Nordenflycht, 2010).

### **3.3 Status**

#### *Definition of Status*

Status is “a socially constructed, intersubjectively agreed-upon and accepted ordering or ranking of individuals, groups, organizations, or activities in a social system” (Washington and Zajac, 2005, p. 284). Status is constructed as individuals that differ along some socially recognizable focal characteristic interact and influence hierarchies develop (Ridgeway, 2001; Webster and Hysom, 1998). These influence hierarchies

occur “through multiple small reactions that the participants rarely scrutinize” (Ridgeway and Cornell, 2006, p. 434). Higher status is attached to actors that retain some advantage such as material resources that provides them with a systematic opportunity to gain influence (Ridgeway and Cornell, 2006). However, the characteristic that becomes the focal point of the status hierarchy need not be the actual attribute that provides advantage (Gould, 2002). Rather, the focal characteristic that confers status and the influence-generating characteristic need only exist simultaneously and consistently across actors within the system (Berger and Fisek, 2006). Eventually actors generalize status attributions to future interactions with others that also exhibit this focal characteristic (Ridgeway and Erickson, 2001).

As a function of collective perceptions, the status hierarchy is self-reinforcing and typically exhibits considerable stability once established (Podolny, 1993; Berger and Fisek, 2006). Over time, status rankings can grow decoupled from the initial structural advantage or the subsequent achievements of the members of the hierarchy (Merton, 1968; Weber, 1978; Ridgeway, 1991). As a result, “incumbents of ranked positions might receive benefits that exceed or fall well short of the “fair” allocation” (Gould, 2002, p. 1146; Podolny, 2005). This dynamic reflects what Merton (1968) termed the “Matthew Effect” where high status actors receive excessive credit and exceptionally favorable interpretations of their actions while low status actors obtain little credit even for notable accomplishments. In this way, status biases the attributions observers make in regard to the actions of other actors within the social hierarchy. (Podolny, 1994).

Even though the status hierarchy is fairly stable, it does evolve over time and actors within the system continuously evaluate one another (Gould, 2002; Washington

and Zajac, 2005). In light of this, those with high status tend to limit interactions with lower status actors “because such relations threaten their own status” through the association (Benjamin and Podolny, 1999, p. 567). Actors do attempt to interact and transact with socially preferred others, provided there is a likelihood that their efforts will be reciprocated (Gould, 2002). However, higher status actors are able to reciprocate with slightly less attention and commitment than lower status actors. This further reinforces the advantaged position of high status actors within the social hierarchy. High status actors that do choose to interact in an observable fashion with lower status actors risk erosion (or leakage) of their high status (Blau, 1981; Whyte, 1981). In this way, leakage operates as a meaningful constraint on high status actors’ decision making (Podolny, 1994; Podolny, 2005). Finally, high status actors are also more likely to be imitated by others of similar or lower status (Podolny and Stuart, 1995).

### *Organizational Status*

Status exists both within and across organizations (Podolny and Phillips, 1996). Status for organizations refers to “the prestige granted the firm because of its position in a social structure rather than its observed performance” (Jensen, 2006, p. 97). Organizations garner status on the basis of their affiliations and patterns of interactions with others (Podolny, 1994). One important type of affiliation that drives organizational status is the status of employees and managers that are tied to the firm (Certo, 2003). Organizations also obtain status through the affiliations they maintain with other organizations in their competitive field (Podolny, 2005). While lower status actors often try to engage higher status actors cooperatively, they can also enhance their prestige through competition with high status actors (Washington and Zajac, 2005).



Status operates as a signal under conditions of uncertainty (Spence, 1973). It permits observers to make inferences about organizations on the basis of observable affiliations rather than unobservable attributes (Podolny 1994). For example in uncertain market contexts, status is often used to infer quality (Podolny, 2005). In this way, “[a]ffiliations and patterns of interactions become the basis for evaluation” because they are “more observable” (Podolny, 1994, p. 460). However a high correlation between status and the truly relevant but difficult to observe characteristics need not truly exist (Benjamin and Podolny, 1999). This can give rise to “a self-reinforcing process in which collective adherence to socially provided assessments reproduces and thereby validates those very assessments” (Gould, 2002, p. 1148).

Higher status confers a number of direct benefits on organizations. Status allows organizations to obtain and retain critical resource commitments (Pfeffer and Salancik, 1978; Fombrun and Shanley, 1990), facilitates premium pricing, increased market share, and lower costs (Stuart, Hoang, and Hybels, 1999; Podolny, 1993; Frank, 1985), and provides organizations with better access to information (Powell, Koput and Smith-Doerr, 1996). Status can support competitive advantage for many organizations and enables better performance as well (Chung, Singh and Lee, 2000; Podolny, 1994). Notably, status represents a critical organizational resource that is essential to survival and success in the investment banking industry that is the focus of empirical study in Chapter 4 that follows (Baum, Rowley, Shipilov and Chuang, 2005; Bonanich, 1987).

### 3.4 Expertise, Status & Decision Making

Structurally, organizations decompose tasks and diffuse responsibility across operating units (Weber, 1978). This is done to promote efficiency and to simplify the management of complex operations (Henderson and Clark, 1990). Decomposition leverages the broad knowledge of the entire organization and permits it to solve “problems that exceed individual limitations” (Gavetti, Levinthal and Ocasio, 2007, p. 527). The division of decision authority is also an important means organizations use to manage conflict (Cyert and March, 1963). As organizations age, they develop routines and procedures that influence the way that decision making authority is distributed (Nelson and Winter, 1982). Specifically, “organizational structure and the division of labor affect the nature of problemistic search, and determine the issues that receive attention” (Jacobides, 2007, p. 456). Organizational structure comes to systematically influence both who is involved in decision making and the cues these individuals attend to within this decision making process (Allison, 1971).

A great deal of a firm’s decision structure is designed to bring the unique competencies of the organization to bear on problems. In this regard, organizations develop unique competencies that distinguish them from competitors and form the basis of competitive advantage (Wernerfelt, 1984; Barney, 1991). A goal of decision making becomes to leverage these strengths and competencies at every opportunity (Marino, 1996). Competence based problem solving comes to represent a preferred problem solving techniques that manifests itself within organizational search (Cyert and March, 1963; Baum and Dahlin, 2007). Specifically, search becomes biased by the specific competencies of the organization (Winter, Cattini and Dorsch, 2007). Problems become

framed by these competencies which systematically influences members of the organization who retain responsibility for specific decisions (March and Shapira, 1987).

Based upon this drive to develop and exploit competencies, organizations rely extensively on experts and high status actors within decision processes as both direct decision makers and advisors (Baum and Dahlin, 2007; Bonaccio and Dalal, 2010). In regard to experts, organizations involve these individuals in decision making when a decision implicates their specialized knowledge (Starbuck, 1992; Vaaler and McNamara, 2004). The general belief is that experts make better decisions relative to non-experts in situations where their domain knowledge is relevant (Wiley, 1998; Van Swol and Snizek, 2005). However, even within large organizations, expertise can be a limited resource and certain competencies become better developed than others (Barney, 1991). As organizations leverage what they do well, they regularly involve those individuals in decision making whose knowledge and skills reflect the more highly developed competencies. In this way, specific experts become integral to decision making generally which can bias search toward defined areas of competence (Dearborn and Simon, 1958).<sup>4</sup>

Unlike experts, high status actors' involvement is not based upon extensive domain knowledge. Rather the prestige and affiliations these individuals maintain within the organization is often the reason they are given direct authority for many decisions (Torrance, 1954; Ridgeway and Berger, 1986). The net result is that both experts and high status actors are frequently directly responsible for decision making within an organization (Winter, Cattini and Dorsch, 2007). This is particularly the case for

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<sup>4</sup> For example, groupthink (Janis, 1971) is a well developed concept within the literature. A key consideration is not only that the individual decision makers within the group share similar mental models and views. For the phenomenon to cause broad issues over time within an organization, the same individuals must make up the group that decides over a sequence of decisions.

important decisions, contentious decisions, and decisions made under uncertain conditions (McAllister, Mitchell, and Beach, 1979). In these circumstances, the involvement of experts or high status actors offers greater assurance that the decisions are widely supported and viewed as legitimate (Zelditch and Walker, 1984; Suchman, 1995).

In addition to direct decision making responsibility, experts and high status actors are also members of the decision audience that evaluate and respond to the decisions of others (Kelley, 1976). A general goal of decision makers is to maximize the acceptance and approval within the decision audience (Zetterberg, 1957; Cialdini, Petty and Cacioppo, 1981). As a result, decision makers often seek the advice of an expert or high status individual prior to making a decision (Van Swol and Snizek, 2005). This occurs not just to improve the quality of the decision, but also because decision makers recognize they need to anticipate the reactions of influential audience members in order to “construct acceptable accounts” and avoid “varying degrees of censure” (Tetlock, 1985, p. 307). In light of this, experts and high status actors often fill the role of advisor and the views they express can substantially alter decision making (Cook and Wall, 1980; Yaniv and Kleinberger, 2000). Specifically, there is a tendency for decision makers to craft decisions that are consistent with the expert or high status advisor’s views (Cialdini, Petty and Cacioppo, 1981; Harvey and Fischer, 1997). This is particularly likely where an advisor is extremely confident (Johnson and Torcivia, 1967; Phillips, 1999) or highly trusted (Bonnachio and Dalal, 2010).

While advice can be influential, decision makers do not ignore their own analysis to simply rely on the views of others (Harvey and Fischer, 1997). Advice does, however,

exhibit a strong tendency to focus the decision maker's analysis on the alternatives emphasized by the advisor (Koehler, Brenner and Tversky, 1997). As a result, search becomes focused on the issues advisors highlight and biased toward the alternatives advisors propose. Thus, through their advisory roles, experts and high status actors exert considerable influence within decision making, particularly if they are highly confident or trusted (Van Swol and Snizek, 2005; Bonnachio and Dalal, 2010). The net result is that decisions favored by an expert or high status individual are more much likely to be enacted. Also, a direct challenge of these decisions by others in the organizational audience carries substantial risk and is generally less likely due to accountability considerations (Tetlock, 1985).

Finally, within organizations situations occur where more than one expert or high status actor is part of the audience for a particular decision. This can present an issue for decision makers if the advice these individuals offer diverges or conflicts (Morris, 1974). Under these conditions, the decision maker must still derive a satisfied outcome (Cyert and March, 1963). This can lead to strategic behavior on the part of both decision makers and members of the audience. In this regard, the decision maker may consciously avoid the input of some members of the organization and seek to limit their role in the decision process. Experts and high status actors may also alter their advice with the knowledge that competing qualified viewpoints are also available (Vaaler and McNamara, 2004; Lichtendahl and Winkler, 2007). In these situations, I assume that decision makers seek to build consensus across a sufficiently broad base within the organization to generate satisfied outcome (Clemen, 1987). However, conflict and a lack of consistency between

experts or high status actors increases uncertainty. This can reduce the accountability for the decision maker and lead to more self-interested decision making (Tetlock, 1985).

### **3.5 Expertise, Status & Misconduct**

#### *Overview*

Both expertise and status can influence the quasi-rational assessment that individuals undertake to determine if they will initiate misconduct. The behavioral process model I develop highlights the role avoidance of ethical confrontation and decision precedents play in organizational misconduct. These two organizational mechanisms are extremely important ways that organizations manage conflict and achieve satisfied outcomes. I maintain that expertise and high status can further enhance the strength of the avoidance norm. I also assert that given the prominent role experts and high status actors often play in decision making, they formulate a substantial number of decision precedents. In light of these considerations, I predict that expertise and high status can contribute to a higher incidence of organizational misconduct.

#### *Initiation of Misconduct: Intentional Misconduct*

As an initial point, nothing I write here is meant to suggest that experts or higher status individuals are inherently likely to be bad actors. However, I do maintain that within organizations some bad actors fill roles as experts or retain high status. Like other organizational decision makers, these individuals employ a quasi-rational approach and initiate organizational misconduct when the expected benefits outweigh the expected costs (Hechter and Kanazawa, 1997). The probability of discovery, the probability of

punishment, and the magnitude of the costs imposed through punishment once again influence this decision (Braithwaite and Makkai, 1991).

Expertise can directly impact an individual's assessment of the costs of misconduct in a manner that increases the probability some individuals will initiate misconduct. Monitoring represents the effort control agents exert to discover misconduct (Stigler, 1970). If monitoring is less effective, the risk that misconduct is discovered falls. This lowers the perceived costs of misconduct and increases the probability that organizational misconduct results (Becker, 1968). Experts are generally more difficult for non-experts to monitor due to their highly specialized knowledge and skills (von Nordenflycht, 2010). Thus monitoring challenges can increase the likelihood that expert will intentionally initiate misconduct.

Similarly some potential bad actors hold high status in organizations and they also use a quasi-rational process to determine if they will initiate misconduct (Finney and Lesieur, 1982). High status reduces the probability that bad actors receive sanctions for their misconduct which also lowers their perceived costs of misconduct. In this regard, organizational misconduct is a "failure event" (Szwajkowski, 1992, p. 402; Scott and Lyman, 1968) that can trigger a settling-up process that sanctions bad actors for misdeeds (Fama, 1980; Schlenker, 1980; Shapiro and Stiglitz, 1984). However, misconduct is typically a complex outcome, with causation and blame at times difficult to assign (Wiesenfeld, Wurthman and Hambrick, 2008). Thus uncertainty about whether sanctions are appropriate for specific actors often exists. This uncertainty leads observers to give high status actors the benefit of the doubt and interpret their actions in the most favorable light possible (Merton, 1968; Podolny, 2005). In this way, high status impedes the

settling-up process and protects high status actors from negative assessments of their behavior. Knowledge of this fact can alter subjective perceptions of the cost of organizational misconduct and increases the probability high status actors initiate these behaviors.

In addition, experts and high status actors retain significant power and this can also lead them to initiate misconduct. Power carries the potential to limit the settling-up process in its own right (Jensen, 2006). Simply put it is difficult to sanction those with power because of concerns about future reprisals such as the loss of access to information or resources these powerful actors control (Pfeffer and Salancik, 1978). To this end, expertise can be exceedingly rare and in high demand (Barney, 1991). For certain skills, an organization may retain only one or two individuals that are true experts within a domain. Similarly, high status actors often have access to significant information and resources (Blau, 1964). As a result, both expertise and status confer power (Crozier, 1964; French and Raven, 1959). Ethical challenges are likely to generate affective conflict which damages relationships among organizational members (Walton and Dutton, 1969; Brehmer, 1976; Korsgaard, Schwieger, and Sapienza, 1995). A breach caused by excessive affective conflict is much more costly for the actors who lack the rare knowledge, skills, or access to valuable resources. This increases the influence of the avoidance norm and makes it less likely an expert or high status actor will face a challenge to their decisions. This can enable misconduct where powerful actors come to recognize the potential for challenge or sanction is remote and their assessment of the costs of misconduct falls.



Finally, equity considerations also carry the potential to increase the probability that experts intentionally initiate misconduct. Equity theory maintains that individuals take action to rectify perceived inequities (Adams, 1965; Adams and Freedman, 1976). They seek a balance in regard to their effort level and outcomes, as well as a perception that the process that led to an outcome was fair (Thibaut and Walker, 1978; Greenberg, 1987). There is considerable empirical support for the existence of equity norms both within organizations and between parties that transact with one another (Schwietzer and Gibson 2008; Greenberg, 1990; Austin and Walster, 1974; Finn and Lee, 1972). When someone perceives inequity, they either change their behavior to restore a sense of equity or they rationalize the fairness of the circumstances they encounter (Greenberg, 1987). At times, one way that actors change their behavior to restore a sense of equity is to initiate misconduct (Skarlicki and Folger, 1997; Greenberg, 1987; 1990).

Experts typically generate greater value through their efforts relative to non-experts (Ericsson and Lehman, 1996). In many situations, however, it is difficult for the non-expert to fully comprehend the true value the expert provides (von Nordenflycht, 2010). As a result, experts may come to believe that they receive insufficient credit or compensation for their efforts. This can create a perception of inequitable treatment. When this occurs, experts may initiate misconduct to extract additional benefits and restore a sense of equity to a relationship (Greenberg, 1987). In this way, equity perceptions can moderate and enhance the positive relationship between expertise and misconduct.

### *Unintentional Initiation of Organizational Misconduct*

Expertise and high status at times also contribute to the initiation of unintentional misconduct. As noted earlier, non-experts can outperform experts in some contexts (Chase and Simon, 1973; Voss, Vessonder and Spilich, 1980). Specifically, this can occur when experts perform tasks or make judgments where they “cannot make use of their domain knowledge” (Wiley, 1998, p. 716). Non-experts can also outperform experts where the cues that trigger the expert’s domain related knowledge do not adhere to expectations (Chase and Simon, 1973; Voss, et al., 1980). Unintentional misconduct can result when the ethical dimensions of a decision are not associated with an expert’s domain knowledge or not a typical consideration in the decision context. In these circumstances experts may mistakenly believe that their decision addresses all the relevant factors, but this is simply not the case. Instead they focus on the limited set of factors tied to their domain knowledge that are typically relevant for this type of decision (Shanteau, 1992).

High status can also lead to inadvertent misconduct. While many experts retain high status, expertise and status are conceptually distinct (Benjamin and Podolny, 1999). Organizations face many ambiguous decisions (March, 1994). In some circumstances, it can be difficult to identify all the factors relevant to a decision (Simon, 1947). Equally challenging, the organization may lack some forms of relevant expertise. Status represents a highly observable attribute that individuals often treat as a proxy for expertise (Podolny, 1994). However, status and expertise are not the same things and high status actors often lack the relevant knowledge or skills of a true expert (Benjamin and Podolny, 1999). Under these conditions, high status actors are in no better position

to arrive at better decisions, but their status ensures they are often involved in the process. Their opinions are just as likely to be mistaken or fail to consider relevant factors, but they receive undue emphasis and deference within the decision process due to their status (Podolny and Stuart, 1995). This can inhibit search and potentially decreases moral awareness and foster amoral decision making (Rest, 1986).

### *Response*

Expertise and high status also increase the probability of misconduct because other organizational actors are more hesitant to affirmatively challenge individuals that retain these characteristics (Tjosvold, Nibler and Wan, 2001). Accountability concerns generally exist for those that challenge another's decision (Pfeffer, 1981; Tetlock, 1985). Expertise amplifies these effects because the expert's specialized knowledge carries considerable (often dispositive) weight (Fable and Yukl, 1992). When an expert is involved, reframing a challenge is also considerably more difficult given the expert's knowledge and skill. In a similar manner, the prestige of high status actors ratchets up the accountability risks for those that challenge their decisions as well (Tetlock, 1989). It is quite difficult to overcome the weight others within the organization will place on the opinions and decisions of high status actors.

In addition, the power and position experts and high status actors hold are again significant to the audience response. Expertise and status are rare and valuable commodities within organizations (Barney, 1991; Ridgeway, 2001). Affective conflict can breach a responder's relationship with an expert or high status actor (Brehmer, 1976). In this way, affective conflict is more costly for non-experts or lower status actors because they risk their access to valuable organizational resources (Pfeffer and Salancik,

1978). Additionally, powerful actors become defensive, aggressive and vindictive if they perceive a challenge or threat (Georgeson and Harris, 2006; Morrison, Fast and Ybarra, 2009). In light of this, the power of the avoidance norm is greater when an expert is the decision maker. The probability falls that individuals within the organizational context will challenge the ethical dimensions of an expert or high status actor's advice or decision. This increases the probability that experts and high status actors will initiate intentional organizational misconduct. The increased power of the norm also permits unintentional acts of misconduct to result due to the unwillingness to challenge experts and high status actors within the decision making process.

Situations can also exist where the expert or high status actors are faced with a response decision. In these situations, I envision that these individuals will largely fill an advisory role (Cook and Wall, 1980; Yaniv and Kleinberger, 2000). As a result, decision makers will seek out the expert or high status actor's input prior to the enactment of a decision (Van Swol and Snizek, 2005). Decision makers will often craft their approach to be consistent with the views of the expert or high status actor (Cialdini, Petty and Cacioppo, 1981; Harvey and Fischer, 1997). Where this is not the case, I maintain that an expert or high status actor will be more likely to challenge a decision than others. However these individuals may still reframe challenges in ethically neutral terms. The avoidance norm remains relevant for experts and high status actors. Ethically motivated challenges that risk affective conflict are generally disfavored and raise accountability concerns for all members of the organization (Tetlock, 1985). Therefore experts and high status actors may challenge a decision, but they still may elect to do so in a manner designed to generate cognitive rather than affective conflict (Jehn, 1994; 1997).

### *Expertise, Status & Precedent*

The organization's need to generate high quality decisions dictates that experts and high status members will be involved in decision making extensively (Baum and Dahlin, 2007). However, time and attention constraints place meaningful limitations on the level of involvement that these individuals can assume within the organizational decision making process (March, 1991). As a result, I argue that experts and high status actors are more likely to be involved in decisions that are either highly visible or important. For these types of decisions, legitimacy and widespread acceptance are essential which makes the involvement of experts and high status members critical (Suchman, 1995). While any decision can form the basis of an organizational precedent, I contend that highly visible and important decisions are more likely to become precedents. In light of this, expert and high status actors likely exert considerable influence on many precedents that decisions come to rely upon. Given the role precedents can play in fostering an amoral decision process, precedent formation also constitutes an additional means through which expertise and high status will be associated with an increased probability of misconduct.

### **3.6 Discussion & Conclusion**

Organizations rely upon experts and those with high status (Cook and Wall, 1980). In most instances this is both appropriate and beneficial. Experts do know a great deal about their domain (Shanteau and Stewart, 1992). They can often utilize this knowledge to improve decision making within organizations (Wiley, 1998; Faraj and Sproull, 2000). Similarly, high status actors can use their personal prestige, connections,

and experience within the organization to improve decision making in many instances (Van Swol and Snizek, 2005). However, individuals with these attributes can also influence the organizational decision making process in ways that potentially increase the possibility for organizational misconduct.

Decision makers at times exhibit bias tied to their functional knowledge and skills (Dearborn and Simon, 1958). Here I outline how organizational decision making processes can enhance these individual tendencies to selectively perceive. The incredibly broad knowledge base that many organizations must build and extend to effectively compete compels extreme degrees of specialization (Simon, 1947). In this sense, there are no general experts. However, the manner in which organizations structure decision making leads experts to filter their analysis through the prism of their knowledge and skills. In this way, experts enter decision making with the well founded belief that their role in the process is to leverage their expertise. As stated, this is often beneficial but can, on occasion, lead to bad outcomes like misconduct.

Relying upon experts or higher status actors is readily defensible within the decision making process (Cialdini, Petty and Cacioppo, 1981; Tetlock, 1985). Those that challenge an expert or high status actor take considerable risk (Harvey and Fischer, 1997). Within organizations, individuals understand that they have a limited stock of decision making capital (Zetterberg, 1957). If they make too many questionable decisions, they will lose decision making authority, prestige and often their job (Tetlock, 1985). If they challenge respected or powerful individuals within the organization they take considerable risk (Pfeffer and Salancik, 1978). The potential need to defend one's position and be accountable at all times is a relevant consideration within organizational

decision making. In the section that follows, I begin to empirically investigate some of the ideas and predictions associated with the process model of organizational misconduct as it relates to expertise and status.

## **APPENDIX 3A – ORGANIZATIONAL MISCONDUCT, AVOIDANCE & PRECEDENT: A COMPUTER SIMULATION**

### **3A.1 - Overview**

Within this appendix I develop a computer simulation that tests the impact of the norm of ethical conflict avoidance and the use of precedent on the potential for misconduct. I also simulate how expertise or high status interacts with these features to impact the probability of misconduct. Computer simulation involves “a model of the behavior of some system” in which the researcher specifies “a set of equations and/or transformation rules for the processes by which the variables in the system change over time” (Harrison, Lin, Carroll and Carley, 2007, p. 1233). Simulations are well suited for the study of complex systems such as organizational decision making (Cohen and Cyert, 1961; Axelrod, 1984). In light of this, the behavioral research tradition offers a number of examples of empirical studies based on this empirical approach (Cyert and March, 1963; Cohen, March and Olsen, 1972; March, 1991; Rivkin and Siggelkow, 2003).

### **3A.2 – Hypotheses Development**

The process model developed within Chapters 2 and 3 provides that ethical confrontation within organizations is avoided because it carries the potential to generate affective conflict (Schein, 1992). This form of conflict is often personal and implicates deep value differences (Jehn, 1994; 1995; Amason, 1996). If severe, it compromises the ability of individuals to cooperate (Brehmer, 1976; Amason and Sapienza, 1997). In light of this, organizations develop a norm of ethical conflict avoidance (Baron, 1988; Tsui, Ashford, St. Clair and Xin, 1995). Organizational members either avoid or reframe



decisions with ethical dimensions in ways that are less likely to generate affective conflict (Walton, 1969; Morrill, 1991). While often effective as a means of conflict management, this approach can also facilitate organizational misconduct. Specifically, the avoidance norm can lower the subjective cost assessment that a quasi-rational actor applies to determine if they will initiate misconduct. In addition, the norm and the reframing process can foster an amoral decision process (Tenbrunsel and Smith-Crowe, 2008). I theorize that this dynamic will enable increased levels of organizational misconduct to result which leads to the hypothesis:

*H1: A norm of ethical conflict avoidance will significantly increase the occurrence of organizational misconduct.*

The theory also maintains that the use of decision precedents within organizations can also increase the probability of misconduct. Like the avoidance norm, the use of precedents also serves to manage and reduce conflict within organizations (Cyert and March, 1963). Precedents eliminate the need to revisit the underlying logic of a previously made decision (Pfeffer and Salancik, 1978). Instead, decision makers focus on whether it is appropriate to apply the precedent to the subsequent decision (Lehman and Ramanujam, 2009). This can also reduce ethical awareness and fade ethical considerations from the decision process (Davies and Crane, 2003). In light of this logic, it follows that:

*H2: The application of decision precedents to subsequent decisions will significantly increase the occurrence of organizational misconduct.*

While precedents are expected to facilitate misconduct, more extensive search for decision alternatives should have the opposite effect. This results because the existence of multiple options requires a deeper consideration of the benefits and drawbacks of the available choices (Cyert and March, 1963). Under these conditions it becomes more likely that moral awareness results and ethical considerations become part of the decision analysis (Rest, 1986; Davies and Crane, 2003). In addition, a broader set of alternatives also provides actors a means to frame objections in factual rather than ethical terms. Put another way, individuals can advocate that one precedent is factually more appropriate to a case at hand and thus challenge the decisions of others in a manner that avoids ethical confrontation. Given this, I hypothesize that:

*H3: Broader search for decision alternatives will significantly decrease the occurrence of organizational misconduct.*

Both expertise and high status are also expected to increase the incidence of organizational misconduct. Specifically, expertise and status can increase the probability that experts and high status actors initiate misconduct. For experts, this occurs because experts are more difficult to monitor (von Nordenflycht, 2010), they retain power based upon their specialized knowledge (French and Raven, 1957), and experts are more prone to mistakes in decision making outside their area of expertise (Chase and Simon, 1973). Similarly, high status actors also retain significant power within organizations (Crozier, 1964) and anticipate that their actions will be interpreted in the most favorable light possible (Merton, 1968). These considerations lower the experts' and high status actors' subjective perceptions of the costs of misconduct. These actors also recognize more

difficult for other actors to challenge the decisions of experts and high status members of the organization (Tetlock, 1985).

*H4a: Expertise will be significantly associated with an increase in the occurrence of organizational misconduct.*

*H4b: High status will be significantly associated with an increase in the occurrence of organizational misconduct.*

### **3A.3 – Model Specification**

The model I develop is a stochastic Monte Carlo simulation based upon a series of defined decision rules and probabilities within the simulated organizations (Harrison, et al., 2007). Here the study involves a very simple agent-based model that simulates the interaction of a decision makers and observers with misconduct available as part of the choice set (Macy and Willer, 2002; Harris and Bromiley, 2007). There are fifteen different models developed within the simulation that vary from one another along certain dimensions to test the different hypotheses. A series of one thousand runs that represented simulated organizations was carried out for each of the fifteen models. Within each of these distinct runs, an organization faced one thousand discrete decisions that were recorded and analyzed. The mean and standard deviation of the total organizational misconduct carried out across the runs are the primary variables of interest collected and examined for each model (Harrison and Carroll, 2006).

The initial decision rule in the Base Model provides that the probability that an organizational decision maker initiates an act of misconduct for each decision is five percent. The generation of a random number determines whether this initial actor selects misconduct within the models. If misconduct is selected, there is a subsequent probability draw in which there is a fifteen percent likelihood that a member of the decision audience will challenge the decision. This low probability of challenge simulates the avoidance norm. It allows for a meaningful probability of challenge, but also reflects the premise that such a challenge is not highly probable. The interaction of decision makers and observers in this manner generates the misconduct outcome for the base model. Specifically, if misconduct is selected by the initial actor and no challenge results, an act of organizational misconduct results. In the Strong Norm Model, the probability of challenge is reduced to ten percent to examine how the strength of the avoidance norm impacts decision making and formally test Hypothesis 1.<sup>5</sup>

The impact of decision precedents is also examined within specific models of the simulation. To accomplish this, an additional decision rule is incorporated relative to the base model that adds a probability that the immediately preceding decision will be applied to the next decision the organization faces. Four different models, referred to as the Precedent Applied Models, are developed. Each of these models carries a different probability that the defined precedent is applied that range from 90 percent to 30 percent. The decision to apply this precedent within the model is again determined by a random probability draw. If the precedent is not utilized, the identical decision rules and

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<sup>5</sup> Expertise and status are theorized lead to a stronger avoidance norm. As a result, there is overlap between the tests of Hypotheses 1 and 4. In this manner, expertise and status represent a special case of the broader phenomenon of a stronger avoidance norm.

probabilities that govern the Base Model apply to the new decision. Namely, there is a five percent probability that misconduct is selected and a fifteen percent probability of challenge. This manipulation allows me to test Hypothesis 2.

In addition, the influence that broader search of decision precedents has on misconduct is investigated. To examine this question, the Extensive Search Model expands the precedent selection rule discussed above to allow decision makers to apply different precedents. These independent precedents are defined by the two decisions that immediately precede the decision faced, and each carries a forty percent probability that it will be selected to govern the decision faced. As a result, there remains a twenty percent probability that the decision is made without any reference to precedent. Where this occurs, the rules and probabilities that govern the base model's decision process for the selection of misconduct and challenge once again apply. This manipulation tests Hypothesis 3.

The remaining eight models simulate the impact of expertise and high status on the decision making dynamic. Both expertise and status are expected to increase initiation through both a lower subjective perception of costs and a strengthened avoidance norm. The Precedent & Strong Norm models allow for the use of the immediately preceding decision as a precedent but also reduce the likelihood of challenge to ten percent if the precedent does not apply. Within the models labeled Precedent & Lower Cost Models, the decision maker can either draw upon the immediately preceding decision as a precedent or make a new decision. In these models, where the precedent does not apply, the probability that the decision maker elects misconduct increases from

five percent to ten percent. This simulates the proposition that experts and high status actors initiate misconduct more frequently. These eight models test Hypothesis 4.

### **3A.4 – Results**

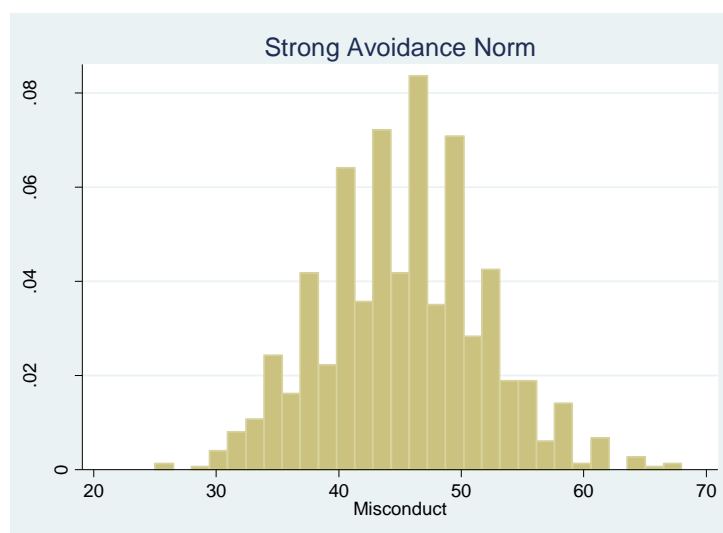
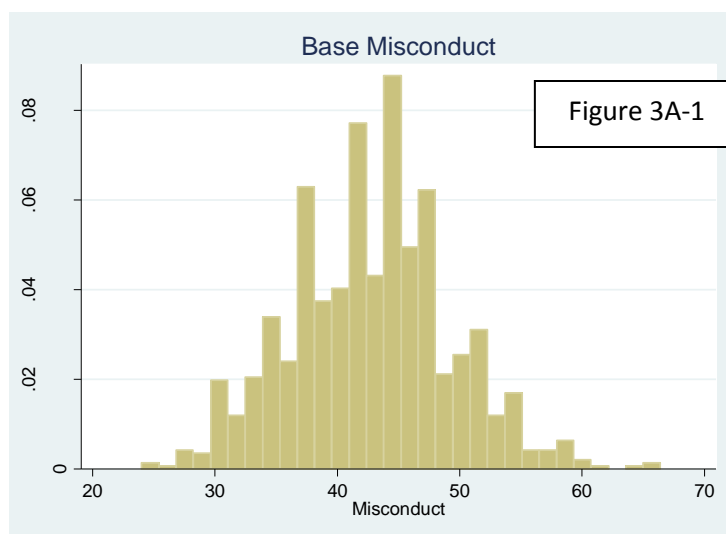
The simulation tracks the number of acts of misconduct that result within the various models. The mean and standard deviations within each model are set forth in Table-3A.1 along with the t-test results associated with the mean comparisons. The primary analysis involves an examination of the differences in the means generated across the various models compared with the base case. In addition, histograms for each model are shown in Figure 3A-1 to allow some examination of any meaningful differences in the distributions that result from the different decision rules. The base model is used as the reference point for these mean comparisons.

The mean level of misconduct experience is significantly higher within the Strong Norm Model compared to the Base Model. Thus Hypothesis 1 is supported. There are no statistically significant differences in the means across the Precedent Applied Models and this means Hypothesis 2 is not supported. However, the standard deviations and distributions associated with the Precedent Applied Models differ a great deal relative to the Base Model. The Precedent Applied Models offer a wider distribution with more extreme favorable and unfavorable outcomes. The Extensive Search Model generates a mean level of misconduct experience that is significantly lower than the base model and this lends support to Hypothesis 3. Finally, all the Precedent & Strong Norm and the Precedent & Lower Cost Models which simulate expertise and status lead to significantly higher levels of misconduct on average. This provides support for Hypothesis 4.

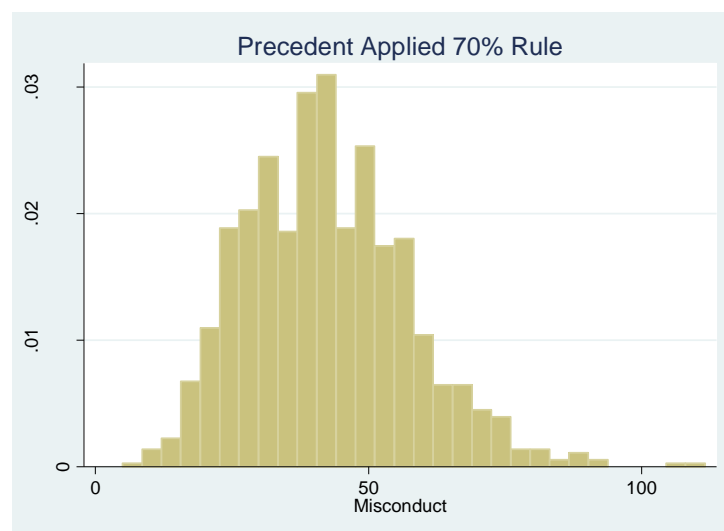
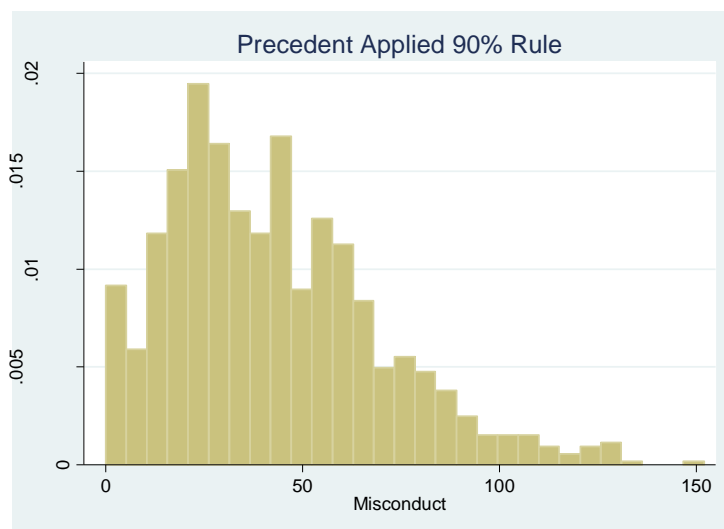
**Table 3A-1**  
**Mean Comparison Across Simulation Models**

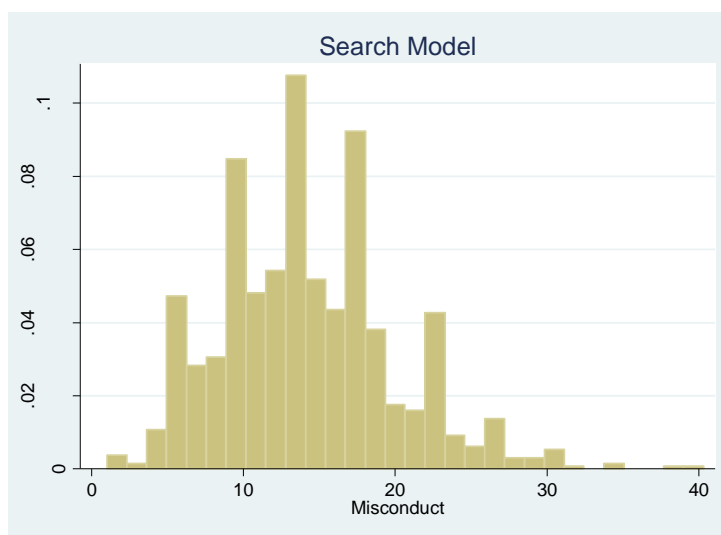
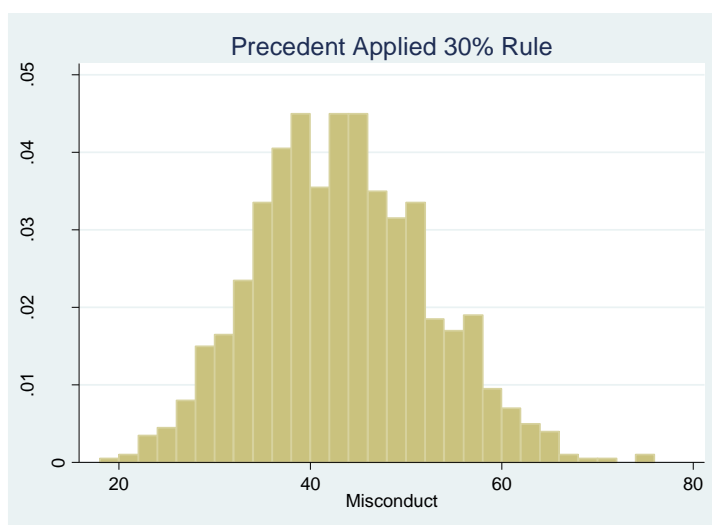
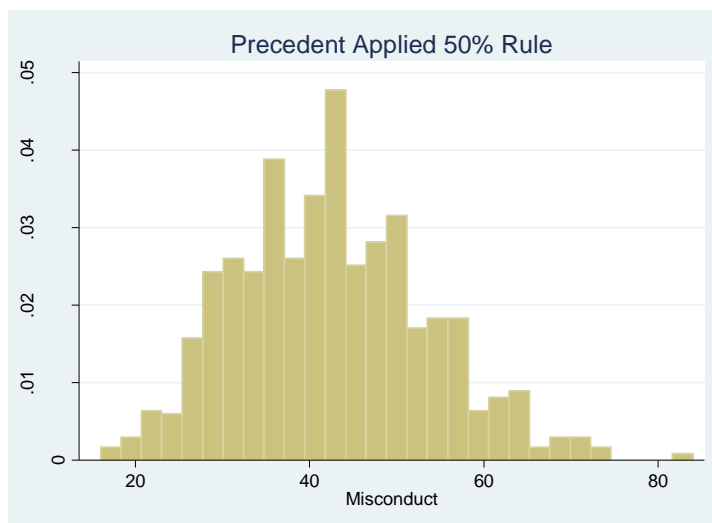
<b>Model</b>	<b>Mean</b>	<b>Stand. Dev.</b>	<b>Hypo Tested &amp; Direction</b>	<b>t-test</b>	
1. Base Model	42.76	6.52			
2. Strong Norm Model	45.32	6.68	H1 -	-8.6422	***
3. 90% Precedent Applied Model	42.61	26.76	H2 -	0.1734	
4. 70% Precedent Applied Model	42.35	15.02	H2 -	0.8034	
5. 50% Precedent Applied Model	42.54	11.00	H2 -	0.5639	
6. 30% Precedent Applied Model	42.84	9.02	H2 -	-0.2046	
7. Extensive Search Model	14.24	5.72	H3+	104.023	***
8. 90% Precedent & Strong Norm	45.26	27.68	H4 -	-2.771	**
9. 70% Precedent & Strong Norm	44.72	15.33	H4 -	-3.712	***
10. 50% Precedent & Strong Norm	45.11	11.35	H4 -	-5.655	***
11. 30% Precedent & Strong Norm	45.33	9.17	H4 -	-7.204	***
12. 90% Precedent & Lower Cost	92.58	40.76	H4 -	-38.165	***
13. 70% Precedent & Lower Cost	92.85	21.91	H4 -	-69.271	***
14. 50% Precedent & Lower Cost	93.28	15.63	H4 -	-94.298	***
15. 30% Precedent & Lower Cost	93.21	12.48	H4 -	-110	***

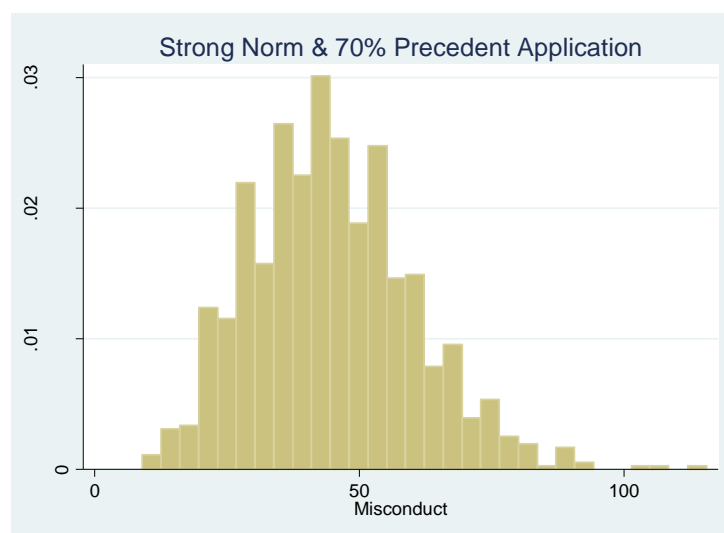
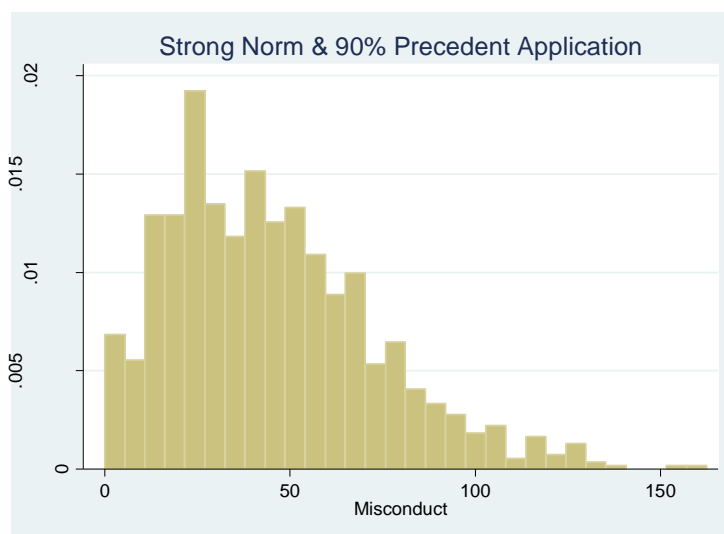
Observations per Model = 1000

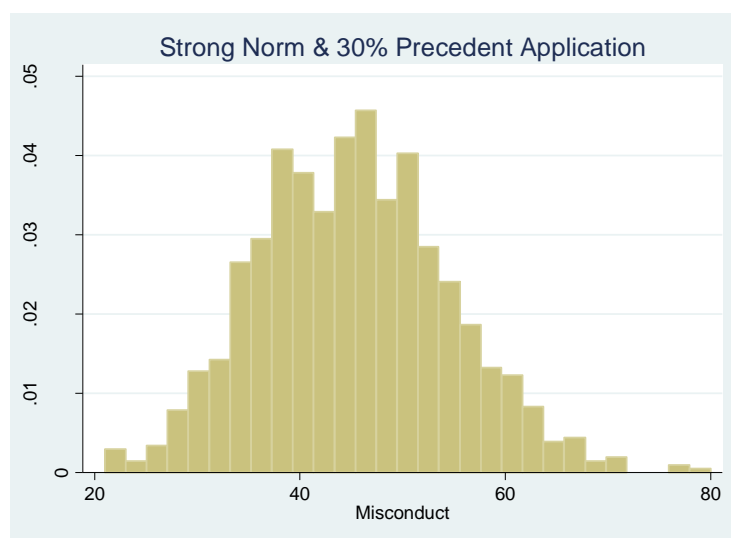
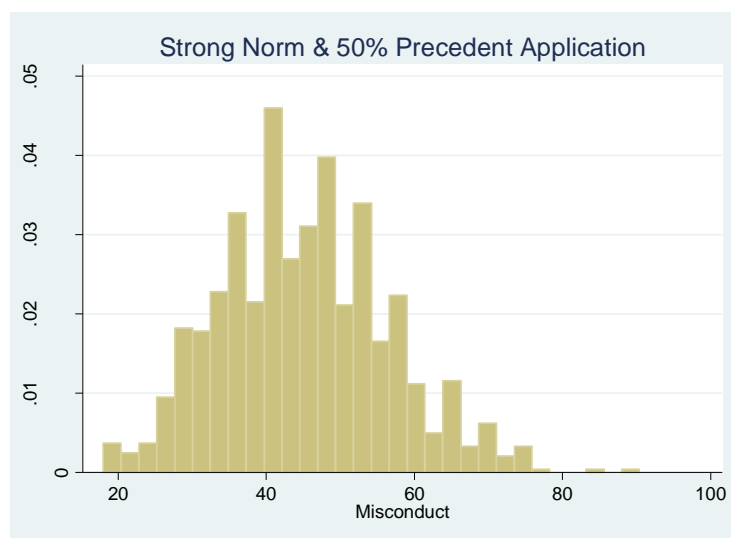


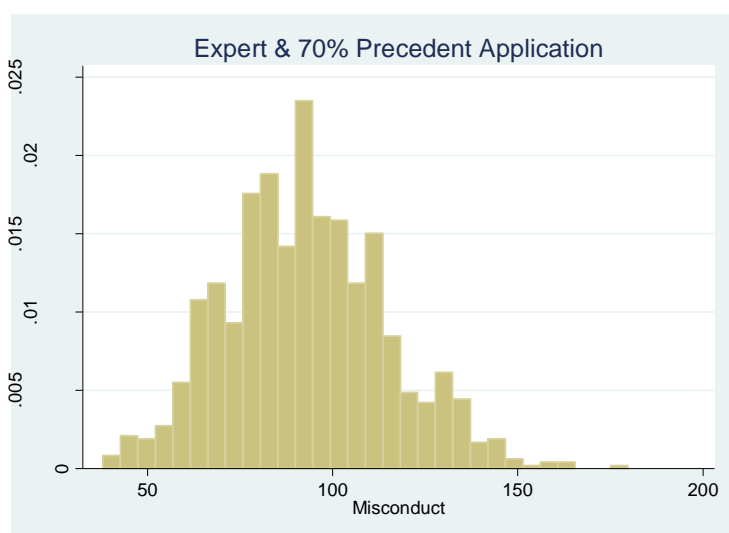
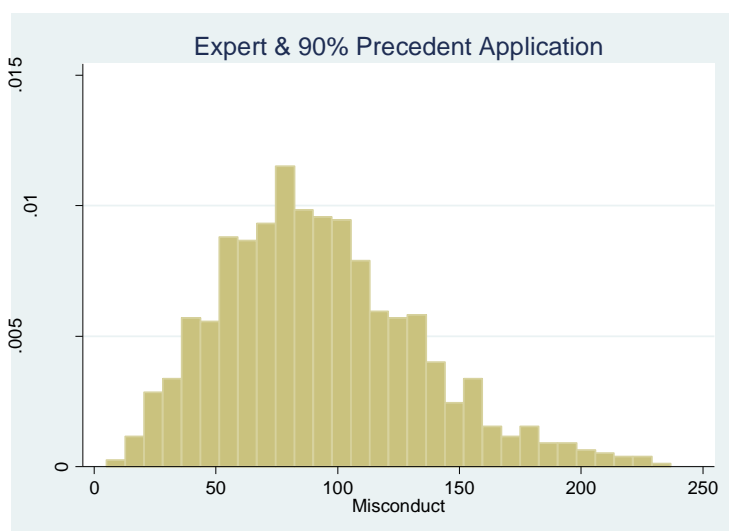


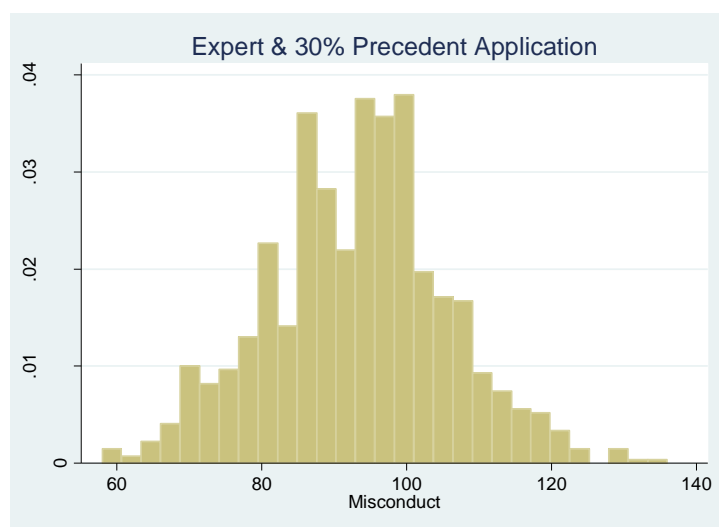
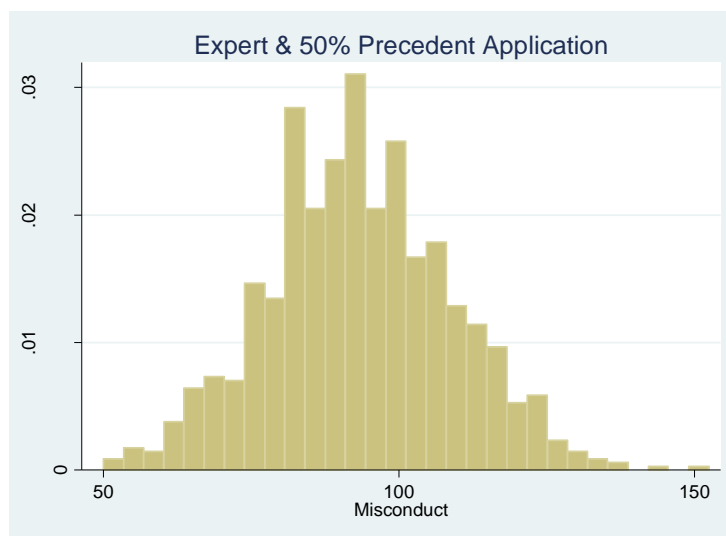












### 3A.5 – Discussion & Conclusion

Within the Base Model, misconduct clusters fairly tightly around the mean. This outcome represents the equilibrium level of misconduct within an organization that balances the costs of the misconduct with the cost of additional controls from the perspective of the organization (Becker, 1968; Stigler, 1970). Hypothesis 1 asserts that a stronger avoidance norm will significantly increase misconduct and it is supported. The decreased probability that a decision will be challenged does lead to significantly more misconduct. There is very little difference in the deviations across the base and strong norm conditions and this is not surprising.

The four Precedent Applied Models that measure the direct effects of the availability of a precedent on decision making are very interesting. Precedent availability on its own does not significantly alter the mean level of misconduct observed relative to the base. However, the distribution of outcomes changes dramatically once the use of precedents is permitted. As the standard deviations and histograms show, higher precedent use leads to a much wider distribution of outcomes. Thus greater reliance on precedents offers the potential for more extremely positive and extremely negative outcomes for a given organization. While the Base Model shows a fairly tight deviation in wrongdoing across the simulated organizations, the Precedent Applied Models replicate a more realistic pattern of observed behavior. It contains the good, the bad, and the truly ugly. It can account for Johnson & Johnson, the average firm, as well as an Enron or Tyco. In this way, the introduction of the precedent component to the model offers a seemingly more realistic view of organizational decision making in terms of organizational misconduct.

The results also show that greater effort in search increases the potential that a more desirable organizational outcome will result. This is consistent with behavioral premises (Cyert and March, 1963). In terms of the process theory I develop, wider search has the potential to allow for more effective reframing of objections. Where broader alternatives are defined, those that are uncomfortable with an ethically suspect approach can focus their support and attention on the other options. In addition, I argue that there is greater potential that the ethical frame will be active when multiple options exist. Decision makers could certainly limit any analysis to simply determine which precedent is factually more appropriate. However, the contrast of two specific existing precedents is likely to precipitate a deeper analysis. This makes the activation of the ethical frame more probable compared to situations where fewer or no alternatives exist (Davies and Crane, 2003).

The models that simulate the effects of expertise and status essentially combine various single precedent decision rules with either an increased probability that decision makers select misconduct or a decreased probability that misconduct is challenged. Both of these probabilities were adjusted by a magnitude of .05. Both of these changes generated significantly higher average levels of misconduct and also wider distributions of outcomes compared to the base model. However the magnitude of these effects was much greater where the probability that the decision maker would elect misconduct was manipulated. This makes sense given that challenge follows misconduct. The effect of the probability manipulation is direct for the initial decision and conditional for the challenge. This leads to the larger impact. It is possible that feedback effects also influence this dynamic in a live organization. Specifically, a failure to challenge may



operate to embolden a bad actor and increase the probability that this specific actor would select misconduct in the future. Testing for these dynamic effects is beyond the scope of the present models.

Looking at the actual results within the models, the introduction of misconduct as a precedent in the organization's memory within many of the models often led to clusters of additional misconduct across the decisions that followed. These results present an interesting way to think about the institutionalization of misconduct and the development of ethical climates or cultures within organizations (Palmer, 2008; Greve, et al., 2010). In general, ethical climate involves "the institutionalized organizational practices and procedures that define what is considered right or wrong within the organization" (Parboteeah, Cullen, Victor and Sakano, 2005, p. 461). Victor and Cullen (1988) indicate that the existence and type of ethical climate within an organization is determined by social norms, organizational form and idiosyncratic firm-specific factors. Here, decision precedents and the decision histories they help generate represent an important firm-specific characteristic that influences whether ethical or unethical outcomes result.

For future research, an interesting extension of the model would be to increase the probability that a precedent is followed once it is established. The expectation I have is that this would primarily increase variability and generate an even wider distribution of outcomes. However, such a decision rule could also have an effect on the mean levels of misconduct because the left side of the distribution is censored at zero (there can be no negative levels of misconduct). Thus the possibility exists that sizable outliers will result and drive up the average, but this remains an empirical question. I would also anticipate that outlier organizations would be a function of the timing of the misconduct decision.

Specifically outliers seem likely to result where misconduct is selected very early in the decision chain which allows the bad precedent to enter the organizational memory at an early stage. However, this timing rationale would also be the case for favorable precedents. This could dramatically reduce the observed level of misconduct and offset the effects of large outliers on the mean tendency. While simulations allow for a great deal of control, there is always some question as to whether the results translate to actual behavior (Harrison, et al., 2007). In light of this, I next examine the relationship between expertise, status and misconduct in the live empirical setting of the investment banking industry.

## **CHAPTER 4 – THE RELATIONSHIP OF EXPERTISE & STATUS TO ORGANIZATIONAL MISCONDUCT: EVIDENCE FROM THE U.S. IPO MARKET**

### **4.1 Introduction**

A central theme developed here is that ethical confrontation poses a grave danger to cooperation within organizations. As a result, a norm develops where this conflict is submerged or recast in less problematic terms. While this enables organizations to make decisions efficiently and effectively on many occasions, I argue it also increases the probability that organizational misconduct can result. Precedents are also used to manage conflict. These too can increase the possibility of organizational misconduct based upon poor decisions entering the organization's memory or through the extension of innocuous decisions to more ethically perilous contexts. In Chapter 3 these ideas are extended to describe how expertise and status can also impact organizational decision making and the decision to initiate misconduct. These two attributes further enhance the probability of organizational misconduct under some conditions.

Direct testing of these arguments is somewhat problematic. An important tenet of the behavioral theory tradition is that the organizational decision making cannot be divorced from the organizational context (Simon, 1947). However, organizations that would allow researchers to observe their decision making processes over any length of time, particularly where the focus of the research is organizational misconduct are few and far between. In light of this, computer simulations similar to the approach I employ in the appendix to Chapter 3 have a rich history within behavioral theory empirical research (Cyert and March, 1963; Cohen, et al., 1971; March, 1991). However the need

still exists for behavioral research that examines decision making outcomes in live organizational settings. In addition, Gavetti, Levinthal and Ocasio (2007) call for “increased attention to the determinants and consequences of multiunit, multibusiness and networked decision making structures” within future behavioral research (p. 532). The empirical study developed seeks to address some of these needs.

Here I examine the influence of expertise and status on organizational misconduct in a live empirical setting. Rather than direct observation of the decision process, I am only able to observe the decision outcome of misconduct after it occurs and is discovered. The organizations I examine are investment banks that operate in the U.S. IPO market. These banks serve as intermediaries between those that seek to raise capital and those that are willing to provide it. I assume that the parties that transact with the investment banks need to maintain a cooperative relationship with these banks and their individual agents. Thus, the need to avoid ethical confrontation and the affective conflict it creates are still relevant. In addition, while companies issue stock infrequently, syndicate relationships with other banks and the pool of investors needed to successfully execute an IPO remain fairly consistent (Loughran and Ritter, 2004). As a result, decision precedents across these groups should develop as well.

## **4.2 Hypotheses Development**

Experts are often given substantial direct decision making authority within organizations (Bonaccio and Dalal, 2010). A probability exists that some of these experts will initiate organizational misconduct when the expected benefits sufficiently

outweigh the expected costs under a quasi-rational assessment (March and Simon, 1958; Finney and Lesieur, 1982; Hechter and Kanazawa, 1997). The extent to which these actors' behavior is effectively monitored impacts this assessment of these costs (Stigler, 1970). More effective monitoring increases the likelihood that misconduct is discovered, which in turn raises the cost of this behavior (Becker, 1968). In this way, effective monitoring deters misconduct. Experts, however, are generally more difficult to monitor due to the highly specialized nature of their knowledge and skills (von Nordenflycht, 2010). This can lower the subjective assessment of the costs of misconduct from the perspective of an expert decision maker faced with the opportunity to initiate misconduct (Braithwaite and Makkai, 1991). As a result, expertise will be positively associated with the initiation of organizational misconduct.

Experts are also generally less likely to have their decisions challenged compared to those without expertise, even where misconduct directly follows from this decision (Tjosvold, Nibler and Wan, 2001). This is the case due to the expert's specialized role and the need to be accountable within organizational decision making (Tetlock, 1985). A non-expert that ignores the advice or challenges the decision of an acknowledged expert takes considerable risk (Cialdini, Petty and Cacioppo, 1981). However, experts can perform worse than non-experts outside of their domain of expertise (Chase and Simon, 1973). This becomes problematic where non-experts assume that the ethical implications of a decision fall within the expert's domain of expertise, but this is not actually the case. Instead, experts often consider a limited number of decision cues tied to the technical aspects of the problem (Stewart, et al., 1992). The failure to challenge permits the ethical dimensions of a problem to fade from consideration (Tenbrunsel and Messick, 1999).

This can lead to decisions to pursue organizational misconduct that result from the mistaken reliance on the expert's advice or opinion.

Finally, the avoidance norm provides that actors often attempt to avoid ethical confrontation because they need to limit affective conflict to maintain cooperative work environments (Jehn, 1995; 1997). Expertise increases the impact of the norm, again due to the unique role that experts play. The specialized knowledge and skill experts possess is, by definition, rare and difficult to replace (Barney, 1991). Therefore the impairment or loss of a cooperative relationship with an expert is acutely problematic for those that rely on the expert's specialized knowledge and skills (Becker, 1964; Williamson, 1975). In this way, non-experts face even greater incentive to avoid ethical conflict with the experts they rely upon (Coff, 1999). This increases the power of the avoidance norm in situations where experts advocate questionable or objectionable behavior. The net result is that expertise leads to a higher probability that bad actors will initiate misconduct and a decreased likelihood that others will challenge questionable advice or decisions of experts. Given this, I propose that:

*H1: Expertise is positively associated with higher levels of organizational misconduct.*

High status influences the potential for organizational misconduct as well. Similar to expertise, some potential bad actors maintain high status. These individuals determine whether to initiate misconduct again through a quasi-rational cost-benefit calculation (Bromiley and Harris, 2006). High status protects actors from negative assessments of their behavior (Merton, 1968; Podolny, 1993). High status actors typically receive the benefit of the doubt in uncertain situations and their actions are interpreted in the most

favorable light possible (Swigert and Farrell, 1977; Uzzi, 1997; Podolny, 2005). In this way, status limits attributions of intent associated with bad behavior which reduces the risk that sanctions result (Giordano, 1983; Fombrun, Gardberg, and Barnett, 2000). This decreases the perceived costs of misconduct for those with high status and they grow more likely to initiate intentional misconduct.

Similar to experts, it is also difficult to challenge higher status actors. These actors typically have considerable prestige within the decision context (Berger, Cohen and Zelditch, 1972; D'Aveni, 1990). They also often retain meaningful power through control over substantial resources (Mills, 1956; Giddens, 1972). In light of these considerations, accountability once again operates to chill dissent with the high status actor's position (Pfeffer, 1981; Tetlock, 1985). In addition, the risk of affective conflict and the corresponding loss of the cooperative relationship is again much more significant for the lower status actor (Thompson, 1967; Jehn, 1994). Thus challenges of high status actors couched in ethical terms will be particularly disfavored. Finally, high status also carries a heightened risk of inadvertent misconduct. This is the case because status is based upon affiliations, not decision making skills or knowledge (Podolny and Phillips, 1996; Jensen, 2006; Lynn, Podolny, Tao, 2009). However, high status actors (who remain difficult to challenge) often fill the role of expert based on their status position and errors can result (Podolny, 2001). The logic set forth leads to the hypothesis that:

*H2: High status is positively associated with higher levels of organizational misconduct.*

Equity considerations can also influence the incidence of misconduct (Greenberg, 1987). Equity requires that both an outcome and the processes that led to an outcome are

fair (Thibaut and Walker, 1978; Greenberg, 1987). Under equity theory, individuals do not simply tolerate unfair situations. Rather they take affirmative steps to alter or rectify perceived inequities (Adams, 1965; Adams and Freedman, 1976). Specifically, they either adapt their performance to restore a perception of equity or they adopt rationalizations to justify the current status quo (Greenberg, 1987). There is considerable empirical support for the existence of equity norms within the workplace and across transactions (Schwietzer and Gibson 2008; Greenberg, 1987; 1990; Austin and Walster, 1974; Finn and Lee, 1972). Notably, research shows that some individuals resort to misconduct where they perceive that the compensation they receive is inequitable (Skarlicki and Folger, 1997; Greenberg, 1990).

Experts generate value within and across organizations based upon their specialized knowledge and skills (Faraj and Sproull, 2000). However at times experts struggle to effectively communicate the true value of their knowledge and skills to non-experts (von Nordenflycht, 2010). I argue that this can create situations where experts feel they are unappreciated and inadequately compensated which leads to perceptions of inequity in the eyes of the expert (Skarlicki and Folger, 1997; Greenberg, 1990). As a result I assert that experts may react to the situation and attempt to remedy this condition through acts of misconduct (Greenberg, 1987). Thus, equity perceptions moderate the relationship between expertise and misconduct. This equity rationale leads to the following hypothesis:

*H3: Inequitable treatment of experts is positively associated with higher levels of organizational misconduct.*



All forms of organizational misconduct carry the potential for sanctions such as direct fines and penalties, stigmatization, ostracism, or the loss of specific relationships and opportunities (Shapiro and Stiglitz, 1984). In this manner, organizational misconduct constitutes a “failure event” (Szwajkowski, 1992, p. 402; Scott and Lyman, 1968) that often triggers a settling-up process where bad actors are held accountable for misdeeds (Fama, 1980; Schlenker, 1980). Sanctions represent the potential costs of misconduct and both their size and the probability that they will result impact the decision making of boundedly rational actors (Becker, 1968; Brathwaite and Makkai, 1991). Direct sanctions can include fines and penalties imposed by regulators or other relevant social control agents (Baucus and Baucus, 1991). An additional type of sanction within markets involves the intentional exclusion of perceived bad actors from future exchanges (Uzzi, 1997; Sullivan, Haunschild, and Page, 2007). In essence, misconduct leads potential customers or partners to sever ties with those they believe are bad actors (Jensen, 2006; Devers, Dewett, Mishina, and Belsito, 2009). This type of sanction occurs to both express disapproval and avoid the risk that others might stigmatize and penalize the client or partner on the basis of their association with the bad actor (Pozner, 2008; Elsbach, 1994; Podolny, 1993).

The likelihood and severity of sanctions for misconduct are influenced by a variety of factors. These include the type of misconduct, the response of the offending organization upon discovery, and the level of trust that existed between the offending organization and its stakeholders prior to discovery (Gillespie and Dietz, 2009). However, the root causes of large scale corporate failures often remain ambiguous and blame is often difficult to assign (Wiesenfeld, Wurthman and Hambrick, 2008). This

makes it uncertain whether an organization will ultimately receive blame and whether market-based sanctions follow. Despite this uncertainty, sanctions generally are expected to result upon the discovery of misconduct and this leads to the following hypothesis:

*H4: The discovery of organizational misconduct is positively associated with market-based sanctions for organizations that engage in this activity.*

Organizational expertise and high status also influence the settling-up process (Fama, 1980). Specifically, expertise and status insulate actors with these attributes from the some of the stigma and penalties that normally follow significant transgressions and lowers the perceived costs of misconduct (Hechter and Kanazawa, 1997). For experts, this outcome is largely a function of the power they retain (French and Raven, 1959). The specialized knowledge of experts can be difficult to replace (Crozier, 1964; Barney, 1991). As a result, sanctions in which actors refuse to deal with an expert in the future can be more detrimental to non-experts (Williamson, 1975). This reduces the probability that market-based sanctions follow the discovery of experts' misconduct and offers the following hypothesis:<sup>6</sup>

*H5: Expertise is negatively associated with the severity of market sanctions for acts of organizational misconduct that are discovered.*

In a similar fashion, high status actors also retain significant power over important resources (Blau, 1964). Loss of the relationship with a higher status actor is therefore

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<sup>6</sup> The emphasis on market based sanctions is an important one. Expertise and high status will not deflect any and all sanctions. In fact, within the empirical context examined here, specific social control agents such as regulators do impose sanctions on expert and high status actors. Market based sanctions are different in that they indicate an unwillingness or inability to work with the bad actor in the future (Devers, et al., 2009). This is a unique type of sanction and the argument I advance is that expertise and status limit its use.

potentially very costly (Thompson, 1967). In addition, high status actors also benefit from generous attributions regarding the positive or negative valence of their actions (Podolny, 1993). Organizational misconduct is a complex phenomenon where causation and blameworthiness are difficult to assess (Wiesenfeld, Wurthman and Hambrick, 2008). Mechanisms such as the Matthew Effect imply that high status organizations receive the benefit of the doubt under conditions of uncertainty (Merton, 1968). This further insulates them from market-based sanctions. This logic leads to the hypotheses that:

*H6: Higher status is negatively associated with the severity of market sanctions for acts of organizational misconduct that are discovered.*

#### **4.3 Data & Methods**

##### *Research Setting: the U. S. Investment Banking Industry & IPOs*

Investment banks active within the U.S. IPO market over the 1997-04 period represents the empirical context I use to test my hypotheses. The investment banking industry is an attractive empirical setting for a number of reasons. First, both the expertise and status of the investment bank are important considerations for companies that issue stock (Eccles and Crane, 1988; Podolny, 1993). In addition, due to the uncertainty that surrounds many IPOs, the status of the investment bank can serve as an important signal that builds credibility for an offering (Carter and Manaster, 1990). This high level of uncertainty also makes it hard for issuing firms to evaluate and monitor the investment bank's activities (Eccles and Crane, 1988; von Nordenflycht, 2010).

In IPOs, investment banks act as an intermediary between the firm's current owners and new investors who seek to purchase equity stakes in the organization (Wilhelm, 2005). A principal role of the investment bank in this process entails pricing the offering to ensure sufficient demand for the IPO exists (Eccles and Crane, 1988). However, this price must also raise sufficient capital to meet the financing requirements of the company and its pre-offering owners (Jenkinson and Ljungqvist, 2001; Ritter and Welch, 2002). In addition to the pricing function, underwriters are expected to support the offering and to make a market in the stock after the IPO (Schultz and Zaman, 1994). Forms of support include price stabilization (Beneviste, Busaba, and Wilhelm, 1996), providing liquidity in the market for the stock (Ellis, Michaely, and O'Hara, 2000), and analyst coverage for the organization after it goes public (Loughran and Ritter, 2004).

To become publicly traded, organizations must file a prospectus with the SEC as required under the Securities Act of 1933. The prospectus outlines the material parameters of the offering and describes the issuing firm's business and risks. Organizations typically engage a specific investment bank to lead a particular offering (Pollock, Porac and Wade, 2004). This lead bank thereafter builds and manages a larger syndicate of investment banks that market and distribute discrete blocks of shares to investors (Corwin and Schultz, 2005). Syndication was adopted to spread the risks associated with the IPO across a number of investment banks (Eccles and Crane, 1988). The lead bank establishes the price with some input from the other banks in the syndicate and provides a due diligence review of the issuer that is relied upon by syndicate members to assess the risks (Tinic, 1988). To build demand for the issue, the lead bank and managers of the issuing firm will meet with potential investors in the period leading

up to the offering. These meetings are referred to as the road show and enable investors to obtain information directly from the people that own and manage the organization prior to the offering (Daily, Certo, Dalton and Roengpitya, 2003).

The pricing and allocation of a particular IPO is accomplished through a process known as bookbuilding (Loughran and Ritter, 2004).<sup>7</sup> In this process underwriters identify investors, market the issue, provide information to build demand, price the issue, and finally allocate shares across members of the syndicate (who in turn allocate shares to specific investors) (Sherman and Titman, 2002). The discretion to allocate shares enables investment banks to favor repeat investors who provide good pricing information and support offerings consistently (Beneviste and Wilhelm, 1997). The information provided by potential investors is significant because it permits investment banks to gauge demand and set an appropriate price.

### *Sample*

The data is drawn from a sample of IPOs offered in the U.S. equity markets during the years 1997 through 2004. IPO activity was robust during the early period (1997-2001), but slowed in the later years. Ritter (2010) provides a database that identifies the offerings that comprise the dataset. This dataset includes all equity IPOs that occurred during the relevant period on any U.S. public exchange with the exception of offerings of publicly traded closed end funds. Data from the calendar year 1997 is employed to derive measures of expertise for the investment banks active in the 1998-2001 period. The data from the 1998-2001 period represents the base sample used to

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<sup>7</sup> While bookbuilding is the dominant means of underwriting in the U.S., alternative forms such as a fairness offering or auction approach are also sometimes employed (Sherman and Titman, 2002).

examine how expertise and status influence organizational misconduct. Finally, the data from 2002-2004 is utilized to examine market share after the discovery of misconduct. The sample sizes are 435 offerings during 1997, 1,312 offerings during the years of 1998 through 2001, and 339 offerings in 2002-2004.

Specific information on the offerings was accessed through the SEC's EDGAR database. The EDGAR database warehouses electronic copies of the documents that publicly traded companies must file with the SEC to comply with U.S. securities laws. The primary source document for the IPO data is a copy of the offering prospectus, identified as either a Form S-1 or Form 424 within EDGAR. The prospectus provides detailed information about the offering size, price, and the aggregate number of shares outstanding upon completion of the IPO (Daily, et al., 2003). In addition, the prospectus includes a discussion of the issuer's business, the risks it faces, and its track record of performance for several years leading up to the IPO. Finally, the prospectus details the complete investment bank syndicate involved with the offering. In this regard, the prospectus identifies the lead investment bank, lists all the banks active in the syndicate, the size of each bank's allotment of shares, and the fees paid to the banks for their efforts.

For the period 1998 through 2001, complete data was available through EDGAR for 1,225 of the 1,312 offerings (93.4%). 540 different underwriters are identified as participants in at least one offering over that time frame. The average offering size in the sample is 8.44 million shares with a median size of 4.5 million shares. The average and median price per share are \$14.15 and \$13.50 respectively. The average size of an investment bank syndicate within the sample is fifteen and the median is fourteen. The

CRSP database provides the data for the closing process of the offerings after their first day of trading, as well as pricing data at different points later in the trading history.

### *Methods*

The hypotheses that relate misconduct to expertise and status are tested with a logit model that uses misconduct as the dependent variable. The level of analysis for these models is each offering that occurs during the 1998-2001 period. The dependent variable is coded “1” where an act of misconduct is observed and “0” otherwise. In contrast, for the hypotheses that examine the impact of expertise and status on the settling-up process, a standard ordinary least square regression is applied. In these OLS models, the change in market share from the period 2002-2004 relative to 1998-2001 period constitutes the dependent variable.

### *Study 1: Logit Model: Organizational Misconduct, Expertise & Status*

#### Dependent Variable

Misconduct represents the dependent variable of interest in the models that test Hypotheses 1, 2 and 3. Misconduct is operationalized here as laddering activity on the part of lead investment banks within the U.S. IPO market during the 1998-2001 time frame. Laddering (also known as a “tie-in agreement”) is “a practice whereby the allocating underwriter requires its customers to buy additional shares of the issuer in the aftermarket as a condition for receiving shares at the offer price” (Hao, 2007, p. 103). Laddering agreements violate securities regulations promulgated by the SEC (Levy, 2004). Investment banks benefit from laddering because the practice can lower their costs and also increase revenues (Griffin, Harris and Topaloglu, 2007). Costs are reduced

because the positive pricing pressure laddering exerts reduces the underwriter's support obligations in the aftermarket (Loughran and Ritter, 2004). Laddering generates additional revenues through the subsequent trades the investor commits to carry out (Loughran and Ritter 2002). In addition, investors often agree to channel a portion of their profits from the laddered IPO back to the investment bank in the form of inflated trading commissions on other transactions (Hao, 2007; Reuter, 2006; Loughran and Ritter, 2004). Given the nature of the activity and its illegality, laddering clearly represents a form of organizational misconduct.

Laddering activity was widespread within the U.S. IPO market over the 1998-2001 time frame (Loughran and Ritter, 2004). A consolidated class action complaint filed on April 24, 2002 alleges that 310 different offerings were laddered over the 1998-2001 period.<sup>8</sup> This lawsuit was used to identify the specific acts of misconduct that comprise the dependent variable. A global settlement for all these discrete matters was entered in 2009 for the amount of \$586,000,000 (Jones, 2009). The settlement covers all 310 matters and includes 55 different investment bank defendants as parties to the settlement. Pursuant to the terms of the settlement, the defendants were not obligated to make any direct admissions of misconduct associated with any particular offering. However, the size of the settlement coupled with the level of detail set forth in the complaint provides significant support for the inference that the banks identified in the complaint engaged in serious misconduct. Additionally, several state attorneys general as well as the U.S. Department of Justice brought civil fraud charges against a number of

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<sup>8</sup> A copy of this complaint can be obtained from Stanford Law School's Securities Class Action Clearinghouse, a database that tracks all federal securities class action claims filed pursuant to the U.S. securities laws. The Stanford site can be found at <http://securities.stanford.edu>.



the same banks in regard to laddering practices (Reuters, 2003). These regulatory claims were also the subject of sizable monetary settlements which lends additional support to the inference that the class action complaint appropriately defines the dependent variable. Finally, in Chapter 5 I specifically examine the extent to which missing or undiscovered misconduct might influence the findings of the empirical models I develop here.

### *Independent Variables*

#### Expertise

Expertise is a key independent variable. I use the data from IPOs completed during the 1997 calendar year to derive my expertise variable. Expertise can be conceptualized in a number of ways such as the specialized knowledge the expert retains (Einhorn, 1974) or the expert's ability to generate better outcomes (Ericsson and Charness, 1994; Shanteau, Weiss, Thomas and Pound, 2002). Here, the approach adopted measures expertise based upon a specific outcome, price. I draw upon the finance literature to develop a model of IPO pricing which predicts a theoretically "correct" price a lead bank should assign to a particular offering (Beatty and Ritter, 1986). The assumption within this approach is that more expert investment banks are better able to both identify and impose this correct price. The larger a bank misses this theoretically correct price, the lower its relative expertise score.

An important feature of the model I use to generate the expertise measure is the phenomenon of underpricing. Historically IPOs experience meaningful increases in their share prices on the first day the issues begin trading (Ibbotson, 1975; Loughran and Ritter, 2002). For example, during the time period of 1980-89 the average increase in

price on the first day of trading was 7%. This average increase on the first day rose to 15% during the period between 1990 and 1998, and soared to an average of 65% during the internet bubble period of 1999-2000. (Loughran and Ritter, 2004). This phenomenon is referred to as underpricing and it is an expected outcome for an IPO (Beatty and Ritter, 2004). Underpricing represents money left on the table from the pre-offering investor's perspectives and provides the IPO investors with fairly consistent and significant windfall profits (Carter and Manaster, 1990). Underpricing also reduces the proceeds the issuer generates through the offering which decreases the funds available to grow the business post-offering (Platt, 1995).

Researchers advance numerous rationales to explain underpricing. One theory reasons that underpricing profits represent necessary compensation to new investors for the risks they incur due to the asymmetric information associated with IPOs (Rock, 1986; Ritter and Welch, 2002). Alternatively, some view underpricing as compensation to draw analyst coverage to the issuing firm (Cliff and Denis, 2004). In addition, investment banks that price offerings too high damage their reputations and face additional costs tied to stabilization activity and legal liability (Nanda and Yun, 1997). Thus underpricing may also serve a risk management function for the investment banks (Gordon and Jin, 1993). There is also evidence that manipulations like laddering contributed to the increased levels of underpricing observed during the 1999-2001 period (Hao, 2007; Ritter and Loughran, 2004).

The phenomenon of underpricing is most developed within the finance literature (Rock, 1984; Beatty and Ritter, 1986; Loughran and Ritter, 1994). I draw upon this work to develop a model to predict an expected level of underpricing. Within the model, the

“correct” price for the offering is the price that leads to a first day closing price that is higher than the offering price, but consistent with expected levels of underpricing.

Overpricing and excessive underpricing indicate poor performance on the part of the lead investment bank. To create a measure of expertise based on this pricing performance, I developed a clustered OLS regression model with the 1997 IPO data. Underpricing is operationalized as the difference between the closing price on the first day of trading and the offering price for the IPO. The observed underpricing represents the dependent variable in this regression.

For the independent variables, Beatty and Ritter (1986) assert that underpricing is a function of the uncertainty that surrounds the offering. Offerings with more uncertainty are underpriced more significantly than those with less uncertainty. The model incorporates multiple proxies for uncertainty and uses these as predictors for the expected level of underpricing. The measures I use to operationalize uncertainty include the offering size, the number of uses for the offering proceeds listed in the prospectus, the status ranking of the lead underwriter, and the percentage of immediate dilution new investors experience upon completion of the offering. Historically, smaller offerings were more speculative and uncertain (Beatty and Ritter, 1986). Additionally, the SEC requires riskier offerings to provide greater detail on how they plan to use the money raised (Daily, et al., 2003). Thus the more uses listed, the greater the uncertainty associated with the offering (Beatty and Ritter, 1986; Rasheed, Datta and Chinta, 1997). Higher status underwriters (discussed below) operate as a signal of quality and reduce the uncertainty of a given offering (Carter and Manaster, 1990). Finally, offerings that are more dilutive are generally more speculative as well.

This model generates a regression equation that predicts the theoretically appropriate level of underpricing. The results of this regression model are set forth in Tables 4.1 & 4.2. I use this equation to compare the predicted underpricing with the observed underpricing for each offering that occurred in 1997. The absolute difference between the actual level and the predicted level of underpricing represent the extent to which the investment bank missed the appropriate price. More expert investment banks will have smaller absolute errors relative to less expert banks in the sample. For banks that led multiple offerings during the 1997 calendar year, the average absolute deviation was computed.<sup>9</sup> This average deviation represents the bank's expertise score. This score operationalizes expertise for the subsequent logit models that examine the relationship between expertise and misconduct.<sup>10</sup> Finally, to control for the potential that a low number of observed lead opportunities might influence the study, I also generated and examined expertise scores that excluded banks with fewer than four offerings. These alternate expertise rankings did not significantly influence the results of the full misconduct models that use the 1998-2001 data. As a result I report results using the complete expertise rankings possible from the full 1997 offering data.

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<sup>9</sup> By using the absolute deviation I eliminate the issue that deviations from overpricing and underpricing would cancel each other out when the average is computed. However, this approach also means that I assume that there is no meaningful difference between overpricing and excessive underpricing as it relates to the bank's level of expertise.

<sup>10</sup> The formal specification of the variable is one minus the average deviation. This was done simply so that higher scores represent more expert organizations. This makes the expertise score easier to describe and interpret. Also, some banks were acquired during the 1998-2001 period. If an investment bank was acquired by another investment bank, a weighted average of the two banks' prior expertise scores was used post-acquisition. If the investment bank was acquired by an entity such as a commercial bank that had no previous ranking, the acquired bank's expertise score was maintained.

**Table – 4.1**  
**Mean, Standard Deviation and Correlation Table**

	<b>Variable</b>	<b>Mean</b>	<b>S.D.</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>1</b>	Log Offering Size	7.54947	0.42680	1.00			
				-			
<b>2</b>	Log No. of Uses	0.59442	0.17817	0.40	1.00		
					-		
<b>3</b>	Underwriter Rank	6.96498	2.23930	0.67	0.33	1.00	
						-	
<b>4</b>	Dilution	0.71361	0.21922	0.06	0.07	0.11	1.00

**Table – 4.2**  
**Underpricing Regression Results**

<b>Variable</b>	<b>Coefficient</b>		<b>S.E.</b>
Log Offering Size	0.057585	*	0.02667
Log No. of Uses	0.107206	*	0.04267
Underwriter Rank	0.008876		0.00609
Dilution	0.06351	+	0.03355
Constant	-0.46791	*	0.1917
Observations	444		
F	6.19	***	
Adjusted R2	0.0538		

+  $p < .10$

\*  $p < .05$

\*\*\*  $p < .001$

Several points about the underpricing model bear consideration. First, the primary objective of the model is to generate an equation that predicts underpricing. I am relying on the established finance literature (Rock, 1986; Beatty and Ritter, 1986) for the underlying theory and do not seek to test specific hypotheses associated with any of the independent variables. Thus the significance and interpretation of the individual coefficients is not an emphasis. Rather the overall significance of the model is the focus. That said, all of the variables included in the model are marginally significant with a p-

value of less than .15. Also, the relationship identified between the proceeds raised and underpricing is positive. This is contrary to the historical relationship relied upon by Beatty and Ritter (1986). However underwriting standards loosened in the late 1990s and this facilitated much more aggressive offerings in terms of size and risk (Ritter and Welch, 2002; Loughran and Ritter, 2004). The positive association found here is consistent with these facts.

### Status

Status of the investment banks represents another key independent variable of interest. Here I utilize a well-established measure of investment bank status applied in both the finance and sociology of organizations literatures (Carter and Manaster, 1990; Podolny, 1994; 2005). Historically, investment banks are separated into a well established and traditionally rigid status hierarchy (Hayes, 1971). The status hierarchy is publicized in the form of deal “tombstones” which are advertisements taken out in financial publications such as the Wall St. Journal that announce that a bank was involved in a particular transaction (Carter and Manaster, 1990). Tombstones list the name of each investment bank that took part in the transaction, with the bank that led the offering listed at the top followed by supporting banks grouped in distinct alphabetized tiers (Podolny, 1994). The lead position of a particular offering does not reflect a bank’s relative status because other factors such as the regional needs of the issuer can enable lower status banks to secure the lead role (Podolny, 1994). However, below the lead, higher status tiers are listed above lower status tiers on the tombstone (Podolny, 2005). Positions on tombstones are zealously defended and there are documented cases where some banks refused to participate in lucrative transactions purely on the basis of the

tombstone positions (Carter and Manaster, 1990). Both Carter and Manaster (1990) and Carter, Dark and Singh (1998) have used IPO tombstones to develop measures of investment bank status. Ritter (2010) has further updated and expanded these rankings and these status scores are available through Professor Ritter's website. I use the Ritter measures of status within this study.

### Inequitable Treatment

Inequitable treatment is operationalized by the compensation the lead bank receives for a specific offering. Investment banks are paid based upon a negotiated spread on the offering, which is typically around 7% (Chen and Ritter, 2000; Hansen, 2000). The spread works essentially as a commission. The syndicate for a particular offering is paid the negotiated spread, and this total fee is divided pro rata among the syndicate based upon the number of shares each bank handles. As an example, where an offering is sold to the public at a price of \$10.00 per share and carries a spread of 7%, a bank that handles 100,000 shares of the offering earns a fee of \$70,000. In this way, the amount of money a given bank earns in an offering is tied to both the spread and the allocation of shares it receives. The direct measure of inequitable treatment is the amount of compensation the lead bank receives.<sup>11</sup> To determine the combined effect of inequitable treatment and expertise an interaction term was generated where the direct measure of inequitable treatment was multiplied with the relevant expertise score.

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<sup>11</sup> This aggregate compensation amount was multiplied by -1 to make the interaction term easier to interpret. This is also the reason the variable was labeled inequitable treatment.

### Control Variables

Industry membership and the type of misconduct can influence the incidence of misconduct (Baucus and Near, 1991). The structure of my sample controls for these issues. Specifically, the study examines one specific type of misconduct that occurs within a single, well-defined industry. In addition, firm effects are controlled through the clustered regression specification. I also examined alternative specifications of the model that used fixed and random effects approaches. The results of these alternate specifications were largely consistent with the model reported. In addition, dummy variables for each year are included in the model to control for the effects of time. A variable for the age of each issuer at the time of the IPO is included as an additional control. Finally, I also incorporate a control for the quality of each offering measured as the percentage return on the stock after 180 days of trading.

### *OLS Model: Market Share & Settling Up*

#### Dependent Variable: Market Share Change

Market-based sanctions are operationalized as the percentage change in lead market share for each investment bank. This represents the dependent variable in the OLS specification. Share change is determined by comparing the number of lead engagements an underwriter secures in the 2002-2004 period with leads from the pre-discovery period of 1998-2001. For the market share OLS models, the level of analysis shifts from the individual offering to the individual bank. This reduces the sample size substantially, with only 127 different banks present in the sample for both periods.



### Independent Variables

Misconduct is the independent variable utilized to test Hypotheses 4, 5 and 6. In the OLS specification the class action lawsuit once again identifies discrete acts of misconduct. Here the aggregate number of claims filed against a particular lead bank within the class action lawsuit represents the independent variable of interest.

Misconduct is also interacted with both expertise and status to examine if these attributes impact the settling-up process. In this regard, the individual bank's expertise score and status ranking were each independently multiplied with the misconduct dummy variable to create two distinct interaction terms. The expertise-misconduct interaction term tests Hypothesis 5 and the status-misconduct interaction term tests Hypothesis 6.

### Control Variables

Finally, within the OLS models that examine market share changes, the sample again controls for numerous factors. Specifically, the sample is drawn from a very single industry that is highly specialized. In addition, a single type of misconduct, laddering activity, is examined. In addition, the expertise and status measures serve as direct control variables in this specification.

## **4.4 Results**

### *Misconduct, Expertise & Status*

The correlation table for the variables included within the logit models that examine misconduct, expertise and status is set forth in Table 4.3. Of note, the correlation between expertise and status is not extremely high. This is consistent with

previous studies that have examined the relationship between these two attributes (Benjamin and Podolny, 1999). The results for the logit models for the 1998-2001 period are set forth in Table 4.4 and Figure 4.1. Expertise is significantly related to misconduct but the sign of the coefficient is negative. Thus more expert organizations are less likely to engage in laddering activity compared to their less expert counterparts and Hypothesis 1 is not supported. In contrast, higher status is significantly and positively associated with greater incidence of misconduct. Hypothesis 2 is therefore supported.

**Table 4.3**  
**Correlation Matrix**

<b>Variables</b>	<b>Mean</b>	<b>s.d</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>
1. Expertise	0.87	0.04	1.00							
2. Status	7.82	1.85	-0.17	1.00						
3. Inequity	-14.32	0.86	0.16	-0.45	1.00					
4. 1998	0.24	0.43	0.03	-0.24	0.32	1.00				
5. 1999	0.39	0.49	-0.02	0.06	0.01	-0.44	1.00			
6. 2000	0.31	0.46	-0.01	0.13	-0.19	-0.37	-0.54	1.00		
7. Quality	0.47	1.63	-0.10	0.04	0.01	-0.11	0.36	-0.23	1.00	
8. Age	12.22	18.75	-0.01	0.15	-0.22	0.11	-0.09	-0.09	-0.08	1.00

**Table - 4.4**  
**Misconduct, Expertise & Status Regression 1998-2001**

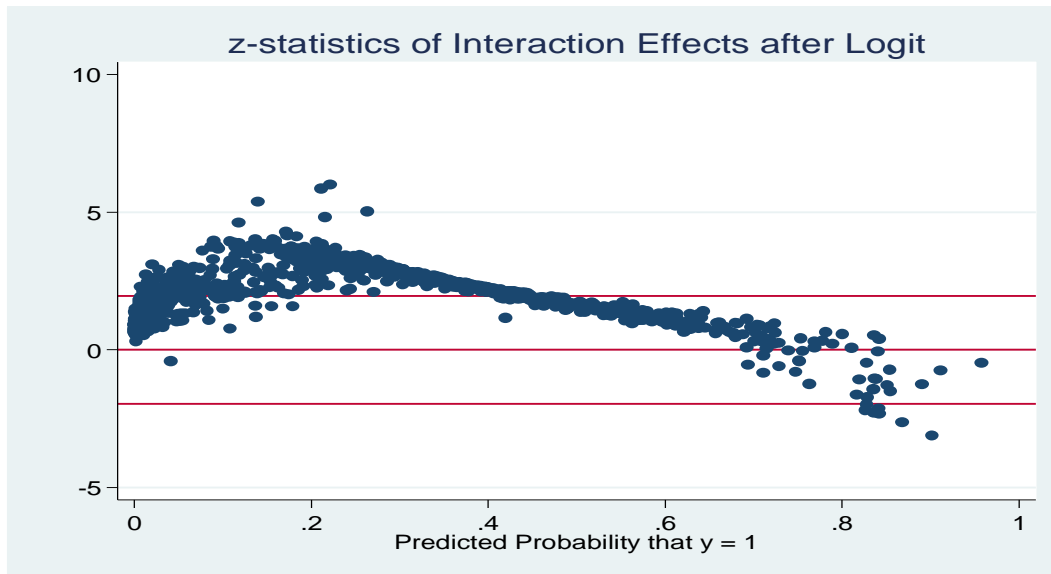
<b>Variable</b>	<b>Hypothesis &amp; Predicted Direction</b>	<b>Control Model</b>			<b>Direct Effects Model</b>			<b>Equity Interaction Model</b>		
Expertise	H1 +				-8.79 ***	(1.87)		59.47		(40.13)
Status	H2 +				0.51 **	(0.20)		0.49 **		(0.20)
Expertise x Inequity	H3 +							0.76 *		(0.38)
Inequity					-0.58 ***	(0.11)		-4.63 *		(2.29)
Year 1998		0.67		(1.02)	1.44		(1.11)	1.57		(1.14)
Year 1999		3.19 ***		(1.00)	3.78 ***		(1.09)	3.88 ***		(1.11)
Year 2000		3.22 ***		(0.98)	3.41 ***		(1.07)	3.51 ***		(1.08)
Quality		0.27 ***		(0.05)	0.19 ***		(0.05)	0.19 ***		(0.05)
Age		-0.04 ***		(0.01)	-0.05 ***		(0.01)	-0.05 ***		(0.01)
Constant		-3.75 ***		(0.94)	-9.12 ***		(2.50)	-67.88 *		
Wald Chi		226.14 ***			282.58 ***			456.90 ***		
Pseudo R2		0.1847			0.2587			0.2608		

\*  $p < .05$

\*\*  $p < .01$

\*\*\*  $p < .001$

**Figure 4.1 – Inequitable Treatment & Expertise Interaction**



Hypothesis 3 examines whether equity considerations moderate the relationship between expertise and misconduct. To test this relationship, I utilized the *inteff* command in Stata to examine the interaction effects (Norton, Wang, and Ai, 2004). As an initial point, the addition of the interaction term eliminates the significance of the direct effect for expertise. The positive sign of the interaction term indicates that as both expertise and the perception of inequitable treatment increase, so does the incidence of misconduct observed in the sample. The interaction term is significant and Hypothesis 3 is therefore supported.

#### *Market Share & Misconduct*

The correlation table and results for the market share models are set forth in Tables 4.5 and 4.6. The initial model indicates that the market does sanction those that engage in more significant levels of wrongdoing. The coefficient for the aggregate claims variable is significant and it is negatively associated with changes in market share.

Thus Hypothesis 4 is supported. The expertise interaction term is not significant which indicates that Hypothesis 5 is not supported. However, the status interaction term is positive and significant. This demonstrates that high status actors that engage in more misconduct gain share after the discovery of their misconduct. Thus status shields organizations from market-based sanctions and Hypothesis 6 is supported.

**Table 4.5**  
**Correlation Matrix**

<b>Variables</b>	<b>Mean</b>	<b>s.d</b>	<b>1</b>	<b>2</b>	<b>3</b>
1. Expertise	0.883	0.075	1.000		
2. Status	4.960	2.105	-0.046	1.000	
3. No. Lead Claims	2.262	9.418	0.015	0.471	1.000

**Table - 4.6**  
**Misconduct Market Share Change 1998-2001 vs. 2002-2004**

<b>Variable</b>	<b>Hypothesis &amp; Predicted Direction</b>	<b>Model 1</b>		<b>Model 2</b>	
No. Lead Claims	H4 -	-0.0004	* (0.00)	-0.0184	*** (0.00)
Expert x Lead Claims	H5 +			0.0042	(0.01)
Status x Lead Claims	H6 +			0.0016	*** (0.00)
Expert		0.0101	(0.02)	-0.0025	(0.02)
Status		0.0012	(0.00)	0.0008	(0.00)
Constant		-0.0135	(0.00)	-0.0007	(0.01)
F		1.8300		13.2600	***
Adjusted R2		0.0373		0.4891	

n = 65

\*  $p < .05$

\*\*  $p < .01$

\*\*\*  $p < .001$

## 4.5 Discussion

The studies demonstrate that expertise has a negative direct association with acts of misconduct. Thus higher levels of expertise are associated with a lower observed incidence of misconduct. This is contrary to the theorized relationship. This outcome may be the result of the empirical context I examine. Specifically, the measure of expertise is tied to the ability of a particular bank to price more effectively. Laddering involves a manipulation of the price (Loughran and Ritter, 2004). The investment bank underprices more aggressively to ensure that the ladder offering generates more substantial gains (Hao, 2007). However, in terms of monitoring, these pricing outcomes are readily observable over time, regardless of whether the misconduct is detected (Stigler, 1970). In this way, the mere commission of the act of misconduct directly undermines the means through which the bank demonstrates its greater expertise. Put another way, laddering makes the expert bank's pricing outcome no better (or possibly worse) than less expert banks, and this can compromise the expert bank's competitive position (Wernerfelt, 1985; Barney, 1991). This weakened competitive position results regardless of whether the misconduct is discovered because the excessive underpricing remains observable at all times. Thus it is possible that expert banks forgo laddering activity to avoid the impairment of a valuable organizational attribute that allows them to survive in an extremely competitive industry.

Higher status is positively associated with misconduct as predicted. In contrast to experts, higher status banks do not directly risk their status simply by excessively underpricing. Mechanisms such as the Matthew Effect should lead observers to attribute the poor pricing performance of a high status actor to factors outside this bank's control

(Merton, 1968; Podolny, 2005). The bank only risks its status if the misconduct is discovered and sanctioned. Here misconduct is ultimately discovered. Monetary sanctions such as regulatory fines and lawsuit settlements did result. Thus high status actors did not avoid any negative effects. However, status only truly erodes if other members of the competitive field reduce their associations with a high status bad actor (Fama, 1980; Jensen, 2006). As the market share models show, this does not occur with regard to the customer affiliations of the high status actors.

The relationship of inequitable treatment and expertise is also interesting. The direct effect of inequitable treatment indicates that as inequity falls (i.e. as the lead bank receives more compensation), misconduct generally increases. This implies an overall greed effect. The lead banks that aggressively pursue their own self-interest through legitimate forms of compensation also seem to pursue forms of illegitimate compensation as well. They are greedy and this shows up in more than one way. Experts, on the other hand, generally engage in less misconduct. As discussed above, this is potentially due to the form of misconduct that I study. However, once experts are treated inequitably in terms of total compensation, they exhibit a higher incidence of misconduct. The argument I advance is that this relationship indicates that experts resort to misconduct to address this inequitable treatment (Greenberg, 1987; 1990). They obtain what they believe is an appropriate level of compensation by alternate means. Concerns that their expertise will be devalued in the future are overcome by the fact that they are unable to obtain fair value for their knowledge and skills in the offering at hand and they react accordingly.



The findings in the market share studies lend support to the interpretation of the direct effects of expertise and status. Specifically, high status insulates banks that commit misconduct from a loss of market share in the years that follow the revelation of their inappropriate conduct. For high status actors, misconduct does not impair an important affiliation that is critical to the bank's continued success. High status seems to frustrate the settling-up process (Fama, 1980). In contrast, significant support for a corresponding expertise effect is not present.

Finally, the different associations that expertise and status exhibit in relation to misconduct are a factor that bears consideration in its own right. Expertise and status are theoretically distinct attributes (Lynn, et al., 2009). Expertise is based on an actor's ability to translate specialized knowledge and skills into better outcomes (Ericckson; Faraj and Sproull, 2001). Status is a function of an actor's affiliations (Podolny, 2005). At times, this distinction is overlooked when empirical studies create operational definitions of either expertise or status (see Benjamin and Podolny, 1999 for an exception). In particular, status measures are used to operationalize quality or expertise (Podolny, 1993). As my findings demonstrate, the differences between expertise and status are very real. Treating measures of these distinct attributes interchangeably is an empirical strategy that carries significant risks. Researchers must use extreme caution should the realities of available or observable data compel them to adopt this strategy.

#### 4.6 Limitations & Conclusion

One limitation of this study involves generalizability of the findings in light of the context. Wall Street is something of a unique and uniquely powerful institution. The risk exists that the relationships tested here would not be found in other contexts. In addition, investment banks capable of leading an IPO all retain high levels of expertise (Eccles and Crane, 1988). The professionalized nature of the workforce and the high level of expertise within the industry might also operate to limit generalizability of the findings. In addition, while the theoretical arguments developed indicate that higher levels of expertise and status lead to misconduct, the structure of my studies does not permit me to rule out the possibility of reverse causation. A further limitation is that the measure of expertise is based exclusively upon a measure of outcomes. Within the context of an IPO, process matters as well. The measure of expertise developed here looks solely at the outcome of pricing effectiveness and does not account for differences in these process considerations.

Finally it cannot be overlooked that the context I examine involves a number of organizations that all engage in a very similar pattern of misconduct over the four-year sample period. My findings may not translate to situations where one or a very small number of organizations engage in acts of misconduct. In particular, high status may not insulate a solitary bad actor from sanctions and stigmatization that result due to organizational misconduct. However, where a large number of actors engage in similar forms of misconduct, the value of status as a signal may not be impaired significantly (Spence, 1973; Podolny, 1994).

Future research is needed on how expertise and status influence both the incidence of misconduct and the severity of sanctions. We have become a knowledge society (Drucker, 1974). The already prominent role of expertise and status in decision making is likely to grow in the future. Also within the period studied, the same form of misconduct was adopted by a host of different organizations. Research that examines how misconduct diffuses and these types of systemic problems result is also needed.

## **CHAPTER 5 - EMPIRICALLY DEFINING MISCONDUCT: THE QUESTION OF OBSERVABILITY**

### **5.1 Introduction**

The study of organizational misconduct presents some significant empirical challenges. Even the establishment of an appropriate formal definition of organizational misconduct is not an easy exercise (Tenbrunsel and Smith-Crowe, 2008). After an appropriate conceptual definition is established, observation and measurement of misconduct often prove quite difficult as well (Trevinio, 1992). This is due to the nature of the behavior studied. Individuals and groups that engage in organizational misconduct face the possibility of significant sanctions upon the discovery of their activities (Baucus and Baucus, 1997). Even relatively minor acts of misconduct carry the risk of embarrassment or a loss of social standing if this conduct is discovered (Wiesenfeld, Wurthman and Hambrick, 2008). More serious transgressions lead to the loss of one's job, criminal liability, fines, and at the extreme, incarceration (Clinard and Yeager, 1980). As a result, organizational actors typically go to great lengths to maintain secrecy and avoid discovery of their misconduct. In light of this, accurate identification of instances of organizational misconduct to utilize as a variable of interest within empirical research is difficult.

Despite these issues, a host of researchers from diverse fields of study have empirically investigated organizational misconduct (Sutherland, 1949; Clinard and Yeager, 1980; Baucus and Near, 1991; Harris and Bromiley, 2007; Mishina, et al., 2010). This growing literature adopts three primary strategies to study misconduct: survey and

interview techniques that generate self-reported measures; experimental data; and retrospective data sets comprised of discovered acts of misconduct. All three approaches have strengths and weaknesses. The analysis developed here focuses on the third category, data derived from discovered organizational misconduct.

While the difficulties in obtaining large datasets on organizational misconduct cannot be ignored, I argue that more needs to be done to address concerns over the quality of this data within business ethics and management research. In particular, greater attention to the processes that drive the creation of the data is required. In addition, researchers should increase the robustness checks within the empirical models that examine organizational misconduct. This requires careful selection of data and multiple specifications of the models to compare the results. Most notably, misconduct research should employ discrete models that address the issue of partial observability (Feinstein, 1999). Observability involves the issue that datasets of discovered misconduct only incorporate actors that were discovered which fails to reflect the true level of misconduct that occurred across the relevant population or sample (Wang, 2011). Here I examine two distinct alternate specifications that test whether the data I rely upon in Chapter 4 present any meaningful concerns with respect to the issue of observability.

## **5.2 Issues within Misconduct Data**

Many researchers study misconduct with large databases of discovered (and typically sanctioned) acts of misconduct (Baucus and Near, 1991; Baucus and Baucus, 1997; Harris and Bromiley, 2007). This is the specific empirical strategy I employ within

Chapter Four. An important characteristic of this data is that a social control agent has affirmatively defined these acts as misconduct (Greve, et al., 2010). This data is attractive because it is generated from live organizational settings. The acts were committed by real individuals grounded in that setting who face significant consequences for their actions (Szwajkowski, 1992). However, data of this type also carries some important issues. The most significant risk is that observed or detected misconduct data fails to reflect the true frequency and severity of misconduct in the sample or population (Wang, 2011). Simply put, studies that rely upon discovered misconduct do not include acts that are either not discovered or not formally sanctioned by the relevant social control agent (Harris and Bromiley, 2007). This data only includes organizations that get caught and punished. The relevant social control agent's enforcement agenda can systematically influence the actors that are discovered and sanctioned (Palmer, 2008; Greve, et al., 2010). Thus, the risk exists that misconduct is only partially observed and this biases the results of the empirical research drawn from the data (Feinstein, 1999).

In addition to observability, the issue of comparability is also extremely important. In order to generate sufficient observations to model and test theory, some studies collapse different types of misconduct into a single variable of interest (Baucus and Near, 1991). This is problematic since very different causal mechanisms may drive different types of misconduct (Jones, 1991; Greve, et al., 2010). As a result, significant relationships become more challenging to both identify and interpret (Baucus and Baucus, 1997). In addition, different types of misconduct are often investigated and sanctioned by different social control agents (Greve, et al., 2010). These distinct control agents at times exhibit dramatically different regulatory philosophies and motives, face

very different resource constraints, and as a result often apply very different enforcement standards (Wiesenfeld, et al., 2008). Even when the social control agent that defines misconduct remains the same, over time standards of acceptable conduct and enforcement appetites change. Much like the issue of observability, the risk exists that identical acts will be labeled as acceptable at one point in time, but become labeled misconduct at a later point by the same social control agent (Becker, 1963). In light of this, significant care is needed to select appropriate data derived from the enforcement activities of distinct social control agents.

The data set I employ has several structural features that address many of the issues associated with comparability. First, the data is comprised of only one type of misconduct, laddering. In addition, the IPO is an event that is observable and occurs at a discrete point in time. Enforcement by the social control agent must follow the act of misconduct within a very short time frame due to the presence of a three-year statute of limitations on securities claims that applied 1998-2001 (Grundfest, 1994). Finally, both the issuer and the investment bank face joint strict liability for any mistakes, omissions or intentional deception in the IPO (Murray, 1999). Thus the legal standard that defines liability is both consistent and clear across the IPOs within the sample.

However, the issue of observability within my dataset remains an important consideration. The analysis and discussion that follows examines the issue of observability through two distinct approaches. First, the results of the base model from Chapter 4 are compared with an alternate specification outlined by Feinstein (1990) and Wang (2011) that is designed to ensure that observability does not impact the results. Second I introduce an additional method called triangulation that is also designed to

examine the results from the base logit models and address concerns that observability influences my findings.

### **5.3 Partial Observability of Misconduct**

Issues tied to partial observability in econometric studies are not uncommon. In general, partial observability creates the potential for biased estimates within models that fail to account for this issue (Poirier, 1980). The overarching strategy to deal with partial observability involves the specification of a model that explicitly recognizes the observed data is potentially incomplete. An alternate model is developed that incorporates a specification that reflects the process that generates the observed outcomes (Heckman, 1979; Poirier, 1980). This additional selection specification is determined through leveraging theory and prior empirical research to outline how the partially observed behavior is actually observed. In this way, the observed data and the process that generates observations are simultaneously used to infer a more accurate probability that the partially observable characteristic is present within the broader sample or population.

As noted, in the specific context of organizational misconduct, it is exceedingly unlikely that samples capture every instance of organizational misconduct over the relevant time frame. To account for this, Feinstein (1990) develops a method he calls detection controlled estimation to explicitly address the partial observability of criminal activity and regulatory violations. Feinstein's approach involves specifying two distinct equations: one that details the probability of a violation and another that outlines the probability of detection given that a violation occurs. Thereafter maximum likelihood



estimation or a nonlinear least square method is applied to generate estimates that adjust for the fact that acts of misconduct occurred that escaped detection. Wang (2011) extends this approach and to the specific context of corporate fraud.

#### **5.4 Testing Observability Issues**

To investigate the issue of observability with my data, I adopt the following strategy. First, I apply detection controlled estimation (Feinstein, 1990; Wang, 2011) to the sample to examine if the results from Chapter 4 change based upon this alternate specification. Second, I employ a novel approach I develop here called triangulation. This second approach is consistent with the partial detection controlled method in that it incorporates a process models for both the commission of misconduct and the detection of misconduct by the relevant social control agent. However, the triangulation approach is distinct from detection controlled estimation in that it tests discrete hypotheses about why a specific social control agent failed to discover or sanction a particular act of misconduct. The two approaches attack the observability question from slightly different perspectives. The nature of misconduct makes it critical to examine the sufficiency of the data from multiple angles to ensure the results are as strong as possible.

##### *Detection Controlled Estimation*

Following Wang (2011), I specified two distinct equations to define a commission function and a detection function. Here, commission is a function of the factors used in the logit model from Chapter 4's analysis:

$$f(x) = a_0 + Expert + Status + Inequity + D1998 + D1999 + D2000 + Quality + Age$$

The detection function incorporates specific variables tied to features of the offering the social control agent can observe ex-post to determine if misconduct occurred. Here the relevant social control agents are the plaintiffs' firms that initiated the class action lawsuit that defines the misconduct variable. Three factors are expected to influence the social control agent's decision to file a claim. More significant underpricing is expected to draw more attention and thus attract claims activity (Loughran and Ritter, 2004).

Underpricing is operationalized as the difference between the closing price and the offer price on the first day of trading. The status of the bank is also observable directly and could influence the decision to institute a claim (Podolny, 2005). Finally in order for damages to exist and support a claim, the share price must fall below the offering price.

In general, larger market capitalization losses (i.e. lower share prices) represent more attractive claims and thus are more likely to draw a suit. The availability of damages was operationalized as either the share price on the date the class action was filed, or the price on the last day the stock traded prior to the class action filing. This latter group captures firms that either went bankrupt or were acquired during the sample frame. The detection model is therefore specified as follows:

$$f(x) = a_0 + Status + Underpricing + Share Price$$

The two models each retain unique independent variables, so identification of the model should be possible (Feinstein, 1990). The full model is executed through the *biprobit* command in stata (Wang, 2011).

*Detection Controlled Estimation Results*

Table 5.1 compares the results of the logit model that relies solely on the class action to define misconduct and the detection controlled specification.

**Table - 5.1**  
**Misconduct, Expertise & Status 1998-2001**

Variable	Hypothesis & Predicted Direction		Direct Effects Model			Partial Obseability		
						<u>Commission Model</u>		
Expertise	H1	+	-8.79	***	(1.87)	-0.10		(2.11)
Status	H2	+	0.51	**	(0.20)	0.41	*	(0.17)
Inequity			-0.58	***	(0.14)	-0.39	**	2.68)
Year 1998			1.44		(0.57)	0.56		(1.14)
Year 1999			3.78	***	(0.66)	1.68	***	(1.11)
Year 2000			3.41	***	(0.60)	1.32	**	(1.08)
Offering Quality			0.19	***	(0.05)	0.06		(0.06)
Age			-0.05	***	(0.01)	-0.01	**	(0.01)
						<u>Detection Model</u>		
Status	H2	+				-0.14		(0.28)
Underpricing						2.72	***	(0.06)
Share Price Decline						-1.06	**	(0.01)
Constant			-9.12	***	(2.50)	-9.78	***	(3.13)
Constant Detection						-4.51		(2.54)
Wald Chi			282.58	***		261.36	***	

\*  $p < .05$

\*\*  $p < .01$

\*\*\*  $p < .001$

The overall results are highly consistent with one exceedingly important exception. The expertise variable is no longer significant under the detection controlled specification. In contrast, the status variable remains significant ( $p = .013$ ). However, we also learn something interesting about the association between status and misconduct.

Status is only significant within the commission function. The status of the bank is not significant in the detection function. Finally, underpricing and the share price are significant in the detection model and the coefficients' signs are in the appropriate direction.

### *Triangulation Specification*

The triangulation approach requires three steps: profile generation; hypotheses development; and hypotheses testing. The first step is to use theory and the observed laddering data to profile offerings where misconduct potentially occurred, but was not detected by the social control agent. Next, a detection theory is developed that seeks to explain why the social control agent reacted differently to the detected observations compared to the profiled observations. This context-specific detection model generates testable hypotheses about why the social control agent failed to identify certain acts of misconduct as misconduct. The final step is to test these hypotheses to determine if it can be inferred that the profiled claims represent instances of unreported misconduct. If this is the case, I can expand the misconduct variable from my original study to include both the detected and profiled observations. The logistical regressions can then be re-examined to determine if the inclusion of the undetected misconduct alters the findings.

### Laddering Profile

Within the IPO dataset, the 310 offerings identified as ladderred offerings in the class action complaint define detected misconduct. Recall that laddering is “a practice whereby the allocating underwriter requires its customers to buy additional shares of the issuer in the aftermarket as a condition for receiving shares at the offer price” (Hao, 2007,

p. 103). Two specific characteristics of the offering that are observable ex-post by the social control agent indicate an offering was laddered. First, laddered offerings exhibit higher demand relative to non-laddered offerings (Loughran and Ritter, 2004). For high demand IPOs, it is difficult for investors to obtain a large allocation of these issues. Laddering arrangement became a means for investors to secure a better allocation under these conditions. Higher demand is operationalized as the percentage of shares of the offering that turnover during the first day of trading. Second, laddered offerings exhibit more significant underpricing (Hao, 2007). Underpricing is operationalized as the difference between the closing price on the first day of trading and the offer price.

To build the laddered profile, I first examine whether both higher demand and underpricing predict claims generally. This is accomplished by using these two predictors with the full 1998-2001 dataset to confirm they are significantly associated with misconduct. The results of this model are set forth in Tables 5-2 and 5-3. Both demand and underpricing are highly significant. The theoretical prediction that these factors are evidence that an offering was laddered is supported. In light of this fact, I calculated the mean values for both demand and underpricing for offerings that were included in the class action complaint. These mean values enable me to examine the entire sample and identify offerings where no laddering allegations were made, but both demand and underpricing were at or above these values. Forty-six additional offerings meet this criterion and these represent the profiled offering sub-set.

**Table 5.2**  
**Correlation**

<b>Variables</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
1. Underprice	1.00									
2. Turnover	0.49	1.00								
3. Expertise	-0.17	-0.07	1.00							
4. Status	0.18	0.24	-0.17	1.00						
5. Inequity	-0.17	0.01	0.16	-0.46	1.00					
6. Year 1999	0.17	0.29	-0.02	0.06	0.01	1.00				
7. Year 2000	0.06	0.05	-0.01	0.13	-0.20	-0.54	1.00			
8. Year 2001	-0.11	-0.14	0.01	0.06	-0.19	-0.21	-0.18	1.00		
9. Quality	0.29	0.24	-0.10	0.15	0.01	0.36	-0.23	-0.08	1.00	
10. Age	-0.17	-0.25	-0.01	0.05	-0.22	-0.10	-0.09	0.16	-0.08	1.00

**Table - 5.3**  
**Triangulation Logit Models**

<b>Variable</b>	<b>Hypothesis &amp; Predicted Direction</b>	<b>Model 1</b>			<b>Model 2</b>			<b>Model 3</b>		
Underpricing	+	1.69	***	(0.39)				1.35	**	(0.43)
Turnover	+				1.24	***	(0.18)	0.55	**	(0.21)
Expertise		-4.56	*	(1.93)	-9.09	***	(1.86)	-5.17	**	(1.96)
Status		0.46	*	(0.21)	0.50	*	(0.24)	0.44	*	(0.22)
Inequity		-0.47	***	(0.13)	-0.98	***	(0.11)	-0.66	***	(0.16)
Year 1999		2.24	***	(0.48)	2.18	***	(0.60)	2.21	***	(0.61)
Year 2000		1.76	***	(0.49)	1.92	**	(0.61)	1.82	**	(0.61)
Year 2001		-0.89		(1.11)	-1.08		(1.29)	-0.75		(1.27)
Quality		0.07		(0.06)	0.17	**	(0.05)	0.08		(0.06)
Age		-0.03	***	(0.01)	-0.04	***	(0.01)	-0.03	**	(0.01)
Constant		-10.33	***	(2.72)	-15.06	***	(3.18)	-13.08	***	(3.47)
Wald Chi		223.83	***		244.69	***		259.32	***	
Pseudo R2										

\*  $p < .05$

\*\*  $p < .01$

\*\*\*  $p < .001$

### Hypotheses Development

The second step in the triangulation process is to hypothesize why the social control agent would overlook the profiled offerings. Whether we treat the social control agent as the individual litigants or the plaintiffs' law firms, damages are a necessary component of a securities claim of this type (O'Hare, 2004). Plaintiffs and plaintiffs' attorneys do not pursue claims that lack meaningful value (Fisch, 1997). Thus if damages associated with a particular offering are not substantial, a ladder allegation becomes much less attractive. Damages in these types of claims are a function of the size of the market capitalization loss associated with the wrongdoing (Ryan and Simmons, 2012). In the specific context of the IPO, the aggregate amount that the share price falls below the offering price therefore represents the most salient measure of damages. This leads to the following two testable hypotheses:

*H1: Offerings included in the class action claim are less likely to remain above the initial offering price compared to profiled offerings.*

*H2: Offerings included in the class action claim experience larger share price reductions relative to their initial offering prices compared to profiled offerings.*

In addition, acquisitions may also influence whether a claim is included within the class action. This is the case for a number of specific reasons. First an acquisition that occurs at an early point in the offering company's history carries the potential to lock in a high share price relative to the initial offering price. This is particularly relevant given the pricing bubble that existed within the IPO market during the early years of the sample period (Loughran and Ritter, 2004). Additionally, an acquisition premium is often paid



(Hayward and Hambrick, 1997; Laamanen, 2007). This will raise the value of the acquired company's shares as well. Finally, acquisitions often eliminate the public float of the acquired firm and leave its equity in the hands of a single entity. This makes it more difficult for the plaintiffs' attorneys to build a broad class of shareholders needed to support a securities class action. These considerations lead to the hypothesis that:

*H3: Offerings included in the class action claim are less likely to be the subject of an acquisition over the sample period compared to profiled offerings.*

Finally, an alternate reason that companies cease to trade publicly is that the business fails. For a publicly traded firm this typically implies a formal bankruptcy filing where those that hold equity receive little to no value for their investment (Weiss, 1990). Bankruptcies thus represent potentially attractive targets for the law firm control agents and the hypothesis that results is:

*H4: Offerings included in the class action claim are more likely to file for bankruptcy protection over the sample period compared to profiled offerings.*

### Hypotheses Tests

The above hypotheses were tested with an additional logit specification. The sample is a subsample of the full 1998-2001 IPO data. The subsample includes both the 310 offerings that were included in the class action complaint and the forty-six additional offerings that fit the laddering profile. The dependent variable is again a dummy variable with offerings that were part of the class action coded as "1" and "0" for profiled offerings. A dummy variable called end price was constructed as "1" if the share price remained higher than the offering price either on the date the class action was filed or on

the date the company ceased to trade and “0” otherwise. The end price variable is used to test Hypothesis 1 and a negative relationship is predicted. The variable referred to as offering percentage is an IPO’s price either on the date the class action was filed or on the date the company ceased to trade divided by its offering price. Offering percentage is utilized to test Hypothesis 2 and a negative relationship is again the prediction. Pricing data for both these two variables was obtained from the CRSP database. Acquisition is a dummy variable coded “1” if the company was acquired prior to the class action filing date and “0” otherwise. This variable tests Hypothesis 3 and a negative relationship is predicted. Finally, bankruptcy is also a dummy variable coded “1” if the company filed for bankruptcy prior to the class action filing date and “0” otherwise. This variable test Hypothesis 4 and a positive relationship is predicted. The identification of both acquisitions and bankruptcies was based upon the availability of share price information from the CRSP site. If a share price for a particular offering was not available from the CRSP database for the full post-offering period, the SEC’s EDGAR database was searched to verify if the company was either acquired or filed for bankruptcy.

Tables 5-4 and 5-5 provide a correlation table and the results of the triangulation logit models. The end price variable is significant and has a negative coefficient which means that Hypothesis 1 is supported. Offer percent is also significant with the appropriate sign which indicates Hypothesis 2 is supported. Similarly, acquisition carries a negative coefficient and is highly significant in both models. Hypothesis 3 is therefore supported as well. The bankruptcy variable is not significant in either model so Hypothesis 4 is not supported.

**Table 5.4**  
**Correlation Matrix**

<b>Variables</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>
1. Offer Dummy	1.00								
2. Offer Percent	0.56	1.00							
3. Acquisition	0.37	0.52	1.00						
4. Bankruptcy	-0.07	-0.06	-0.04	1.00					
5. Status	0.07	0.05	-0.06	0.01	1.00				
6. Year 1999	-0.02	-0.09	0.00	0.14	-0.07	1.00			
7. Year 2000	-0.11	-0.09	-0.12	-0.13	0.09	-0.89	1.00		
8. Year 2001	0.15	0.04	-0.01	-0.01	0.03	-0.07	-0.04	1.00	
9. Age	0.01	0.07	-0.01	-0.04	0.01	-0.07	0.10	0.06	1.00

**Table - 5.5**  
**Triangulation Logit Models**

<b>Variable</b>	<b>Hypothesis &amp; Predicted Direction</b>	<b>Model 1</b>			<b>Model 2</b>		
End Price	H1 -	-0.99	**	(0.42)			
Offering Percentage	H2 -				-0.71	**	(0.26)
Acquisition	H3 -	-5.05	***	(0.99)	-4.74	***	(0.97)
Bankruptcy	H4 +	-0.90		(0.94)	-1.06		(0.89)
Status		0.90	**	(0.28)	0.91	**	(0.14)
Year 1999		1.64		(0.96)	1.63		(1.08)
Year 2000		1.23		(1.01)	1.23		(1.06)
Age		-0.02		(0.02)	-0.02		(0.01)
Constant		-6.34	*	(2.53)	-6.15	*	(3.13)
Wald Chi		69.52	***		58.54	***	
Pseudo R2		0.3846			0.40		

\*  $p < .05$

\*\*  $p < .01$

\*\*\*  $p < .001$

In total, three of the four triangulation hypotheses have strong support. In light of these findings, the inference clearly exists that profiled claims represent instances where misconduct occurred, but was not treated as such by the social control agent. Thus it is advisable to incorporate the profiled claims into the misconduct dependent variable and re-run the models. This allows me to determine if the findings from Chapter 4 remain consistent when the unobserved misconduct is also considered. The results from this additional specification are set forth in Table 5.6. The results of the models from Chapter 4 are highly consistent with the triangulation models in which the dependent variable includes the profiled offerings. This offers support for the position that the findings across the models are robust and not subject to bias tied to the observability problem.<sup>12</sup>

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<sup>12</sup> The market share models were not re-examined because no impact is expected. Specifically, the market sanctions flow from the discovered misconduct and thus the issue of observability is not directly an issue.

**Table - 5.6**  
**Misconduct, Expertise & Status Regression 1998-2001**

Variable	Hypothesis & Predicted		Direct Effects Model			Expanded Direct		
	Direction							
Expertise	H1	+	-8.79	***	(1.87)	-8.25	***	(1.89)
Status	H2	+	0.51	**	(0.20)	0.40	**	(0.14)
Inequity			-0.58	***	(0.11)	-0.51	***	(0.12)
1998			1.44		(1.11)	2.08		(1.09)
1999			3.78	***	(1.09)	3.81	***	(1.08)
2000			3.41	***	(1.07)	3.54	**	(1.06)
Offering								
Quality			0.19	***	(0.05)	0.27	***	(0.06)
Age			-0.05	***	(0.01)	-0.05	***	(0.01)
Constant			-9.12	***	(2.50)	-7.62	**	(2.47)
Wald Chi			282.58	***		256.93	***	
Pseudo R2			0.2587			0.2480		

\*  $p < .05$ \*\*  $p < .01$ \*\*\*  $p < .001$ 

**Table - 5.6 (Continued)**  
**Misconduct, Expertise & Status Regression 1998-2001**

Variable	Hypothesis & Predicted		Interaction Model			Expanded Interaction		
	Direction							
Expertise	H1	+	59.47		(40.13)	59.11		(35.94)
Status	H2	+	0.49	**	(0.20)	0.39	**	(0.13)
Expertise x								
Inequity	H3	+	0.76	*	(0.38)	0.78	*	(0.38)
Inequity			-4.63	*	(2.29)	-4.54	*	(2.10)
1998			1.57		(1.14)	2.19	*	(1.09)
1999			3.88	***	(1.11)	3.90	***	(1.08)
2000			3.51	***	(1.08)	3.64	**	(1.07)
Offering								
Quality			0.19	***	(0.05)	0.27	***	(0.06)
Age			-0.05	***	(0.01)	-0.05	***	(0.01)
Constant			-67.88	*		-65.61	*	(30.66)
Wald Chi			456.90	***		293.97	***	
Pseudo R2			0.2608			0.2504		

\*  $p < .05$ \*\*  $p < .01$ \*\*\*  $p < .001$

## 5.5 Discussion

### *Observability*

The issue of observability is extremely significant. It lurks in the background with all research that relies upon misconduct data derived from the decisions of social control agents. The specifications developed by Heckman (1976; 1979), Poirier (1980) and Feinstein (1990) are well established and frequently cited within a variety of literatures. However, some variation of these approaches is typically not applied within the management and business ethics literatures that examine organizational misconduct. This needs to change and should serve to strengthen the growing body of empirical research that examines organizational misconduct. In addition, analyses of separate commission and detection functions allow the researcher to obtain a more nuanced view of misconduct (Wang, 2011). The implications for both theory and policy are often quite different if a factor influences detection rather than commission.

The triangulation method I introduce here is also a meaningful contribution to the empirical research on organizational misconduct. An advantage of the triangulation approach is that it focuses the analysis on the unique decision process of the social control agent that generates the data. It also allows the researcher to profile and examine specific alternate data points that may represent undetected acts of misconduct. These considerations focus attention in a detailed manner on the varied motives and priorities of different social control agents. As an example, the budget available to regulatory agencies for enforcement dramatically influences detection capability. In general, when resource constraints become more pronounced, detection and enforcement drop (Stigler, 1970). However in all budgetary environments, a particular social control agent

maintains certain priorities and still faces affirmative choices about where it elects to focus its resources. The process of hypothesis testing compels the researcher to drill down on these more subtle aspects of the detection agenda to obtain better knowledge of how the data develops. Finally, triangulation also represents an alternative method to examine the issue of observability in situations where the detection controlled estimation model cannot be identified (Feinstein, 1990).

A weakness of both the detection controlled estimation and triangulation approaches is that the researcher needs a well developed theory to derive the commission and detection functions. This was an advantage of the empirical context examined here. The finance literature has extensively developed the phenomenon of underpricing and the underlying rationale for laddering behavior (Rock, 1986; Loughran and Ritter, 2004). This allows a specification of factors that are associated with the commission of these acts. It is also the basis used to derive the detection function and identify profiled offerings. In contrast, application of these techniques is much more difficult for exploratory research that aims to investigate more novel claims where theory is less well developed.

As noted previously, collapsing data from different social control agents into a single dependent variable carries risks (Baucus and Near, 1991). This approach makes it particularly difficult to apply detection controlled estimation since this method requires a single, consistent detection function. This is one potential unique benefit to the triangulation approach. This method allows researchers to test different hypotheses for different elements of the data tied to specific social control agents. While different causal mechanisms are still a relevant concern when different forms of misconduct are collapsed



into a single variable, the triangulation method offers some additional flexibility to address observability where this research strategy is necessary.

### *Status, Expertise & Misconduct Revisited*

Several important considerations become clear based upon the comparison of the logit model results from Chapter 4 with the results of the detection controlled and triangulation models. First, these efforts provide considerable confidence that higher status is significantly associated with a greater incidence of misconduct within the empirical context I investigate. The status findings are consistent and remain significant throughout each and every specification. However, the two additional specifications offer somewhat competing evidence about how status impacts misconduct. Specifically, the detection controlled technique includes status in both the commission and detection equations. A significant relationship only exists in the commission stage, not in the detection stage. In contrast, status is both positive and significant in the triangulation test that examines what dictates whether an offering is included in the class action. This supports an inference that higher status banks draw more enforcement attention from the social control agents of interest. Thus while higher status banks are positively associated with greater incidence of misconduct, I cannot rule out that some of this effect may be driven by the affirmative enforcement choices of the social control agent that generates the data.

There is less consistent support for the expertise relationship. Detection controlled estimation does not indicate a significant relationship between expertise and misconduct. This is certainly grounds for some caution in regard to the initial findings. That said, the logit models from Chapter 4 and the triangulation specifications are

extremely consistent in regard to the expertise findings. Thus while caution is warranted, considerable support remains for both the negative direct association between expertise and misconduct, and the positive association between the expertise-inequity interaction and misconduct.

## **5.6 Conclusion**

Idiosyncrasies of the data generation process have potentially broad implications. In the studies set forth here, litigation and settlement data are utilized to examine the issue of observability. Here the nature of the litigation process and the elements necessary to sustain a cause of action influence the data that results. All methods of empirical research have strengths and weaknesses and no dataset is ever perfect. Researchers will always need to make some difficult judgments about how to best study a particular phenomenon of interest. This is why a broad research agenda requires varied approaches. In this regard, organizational misconduct is an intriguing and important area of management and business ethics research. The nature of the conduct studied makes it a challenge to obtain good data to use in empirical studies. Rather than accept these limitations, it is incumbent upon those that study misconduct to develop creative ways to improve the quality of the data we use to continue to advance our understanding of this critically important area of research.

## **CHAPTER 6 – SUMMARY OF FINDINGS, FUTURE RESEARCH & CONCLUSION**

### **6.1 Summary of Findings**

My dissertation investigates the phenomenon of organizational misconduct through a process framework. I use a behavioral theory lens to examine how individual and organizational decision processes interact to increase the probability that organizational misconduct results. Organizational actors actively manage conflict within decision making processes to limit affective conflict (Baron, 1988; Tsui, Ashford, St. Clair and Xin, 1995). Ethical confrontation is one particular organizational interaction that can often leads to affective forms of conflict (Schein, 1992). Therefore I argue a norm of ethical conflict avoidance develops within many organizations. This norm both enables aggressive behavior by some actors and limits ethical awareness within organizational decision making generally. Lack of awareness leads to an amoral decision making process where the probability of misconduct is increased (Tenbrunsel and Smith-Crowe, 2008).

Decision precedents also represent an important means organizations utilize to manage conflict. Precedents permit organizational actors to avoid making decisions anew and instead focus decision analysis on the factual determination of whether the precedent applies (Pfeffer and Salancik, 1974). Precedents are also extended to contexts but their underlying logic is still not revisited. The use and extension of precedents can also reduce moral awareness and lead to an amoral decision making process (Davies and Crane, 2003). This also creates the potential for increased levels of organizational misconduct.

I also develop how expertise and high status can increase the probability of organizational misconduct. These relationships are tested in the computer simulation in the Appendix to Chapter 3 and through the econometric study set forth in Chapter 4. In the simulation I am able to demonstrate significant differences in the levels of misconduct that are consistent with my theoretical predictions. Most notably, the models that incorporate precedents generate significant results and the output resembles the realistic behavior of organizations. The econometric model also provides strong support for the hypothesized relationship that high status is associated with increased levels of organizational misconduct. The relationship between expertise and organizational misconduct, however, is more nuanced. In the empirical context I examine, expertise is negatively associated with misconduct. As I argue within Chapter 4, this may be a function of the type of misconduct I study. Despite this, I am still able to find support for the idea that inequitable treatment of experts may trigger increased levels of misconduct.

Finally, I also directly examine the question of partial observability of misconduct within my econometric data (Feinstein, 1990; Wang, 2011). Within Chapter 5 I show that the status finding remains robust under both the detection controlled estimation method developed by Feinstein (1990) and the triangulation method I develop within the dissertation. In addition, I also develop consistent results for the expertise findings, but only under the triangulation method. While far from conclusive, these additional specifications add strength to the findings and provide comfort that the issue of observability does not create bias within the econometric models.

## 6.2 Future Research

### *Diffusion of Misconduct across Organizations*

One broad area for future research involves the diffusion of misconduct across organizations. Within Chapter 4, I examine how some of the ideas I develop might apply across organizational boundaries. A very interesting question I do not directly address involves the impact expertise and status have on the diffusion of misconduct across organizations. There is a real need within the research on organizational misconduct to investigate the process of proliferation across organizations and industries (Greve, et al., 2010). Research suggests that highly successful and high status organizations are subject to imitation by others within their industry (DiMaggio and Powell, 1983; Haveman, 1993; Podolny and Stuart, 1995). This effect is a function of various factors that include the relatively high degree of visibility of these organizations (Greve, 2000), the overall legitimacy these organizations maintain (Washington and Zajac, 2005), and the desire of others to mimic their actions to convey that they too are legitimate (Rao, 1994). Given these facts, both expertise and high status could be influential in the spread of misconduct. Misconduct may represent an additional practice that organizations observe and imitate because they believe it is either advantageous, legitimate, or signals they too are successful or prestigious organizations.

### *Aspirations Levels & Referents*

Another interesting area for future research related to the spread of misconduct involves the question of aspiration levels and referents. Research on behavioral theory and misconduct has begun to examine the impact of aspiration levels and referents

(Harris and Bromiley, 2007; Mishina, et al, 2010). Competitors often treat one another as referents and this may influence the diffusion of misconduct (Cyert and March, 1963). In regard to misconduct, aspiration levels may adjust based on observation of how aggressive practices benefit referents in the near term. As an anecdotal example, in the financial crisis of 2008, banks and other investors collectively took inordinate amounts of risk on complex mortgage and debt securities. In regard to this behavior, Chuck Prince, former CEO of Citigroup is famously quoted as stating: “[w]e have to dance until the music stops.” What Prince’s words demonstrate is that even when organizations view competitor’s practices as questionable, at times they give in to competitive realities and adopt these practices. How this process plays out and evolves is an area that likely presents very fertile ground for additional theoretical development and empirical study.

### **6.3 Conclusion**

As noted at the outset, organizations significantly influence the lives of billions of people globally. They have enabled truly stunning accomplishments in human history. However, they can also do significant harm. If history is any indication, this is unfortunately unlikely to change. As a result, organizational misconduct continues to represent a vitally important area of research. The theory and empirical models I develop offer some insight about the process of organizational misconduct. However, they hardly tell the full story. Even though a complete understanding of this complex phenomenon will likely prove elusive, continued research remains necessary and worthwhile.

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