

# **Corporate Governance and Business Ethics in Iceland**

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# **Corporate Governance and Business Ethics in Iceland: Studies on Contemporary Governance and Ethical Dilemmas**

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United Kingdom – North America – Japan – India – Malaysia – China

Emerald Publishing Limited  
Howard House, Wagon Lane, Bingley BD16 1WA, UK

First edition 2023

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**British Library Cataloguing in Publication Data**

A catalogue record for this book is available from the British Library

ISBN: 978-1-80382-534-2 (Print)

ISBN: 978-1-80382-533-5 (Online)

ISBN: 978-1-80382-535-9 (Epub)



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Certificate Number 1985  
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# Acknowledgments

We would like to first acknowledge the students from the University of Iceland's Corporate Governance and Business Ethics classes that contributed to the case studies contained within this book. Their passion, insight, debate, and hard work will benefit future business students in Iceland and beyond.

Our colleagues and administration from the University of Iceland, Copenhagen Business School, and other institutions showed incredible support for our teaching and research approach as we look to advance methodologies within this area of study.

We would also like to recognize all of the representatives from Icelandic organizations and companies who read drafts and provided valuable feedback to ensure the case studies were factual and accurate.

Similarly, we would like to recognize the diligence and perseverance of national and international business journalists who brought forward many important corporate governance and ethical questions in the mainstream media.

We appreciate the support of the team at Emerald Publishing for believing in this project and the tireless efforts that go into bringing a book to life.

Finally, we would like to thank our families for the ongoing support and encouragement throughout the entire journey.

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# Chapter 1

## Introduction

In 2008, Iceland experienced an earth-shattering social event – the collapse of the country’s banking system. To learn from the crisis, the Icelandic government assembled a Special Investigating Committee to study the causes, which found insufficient legal and ethical compliance by some but not all managers and leaders of Icelandic financial institutions. A special sub-committee looking into the ethical and societal causes discovered courses in business ethics had been discontinued in the years leading up to the catastrophic crash.

Following the crisis, a strong consensus formed on the need to strengthen business ethics and governance education at the university level in Iceland. Clauses were added to the University of Iceland policy for 2011–2016 on the importance of ethics education and training in critical thinking. The current policy of the University of Iceland for 2021–2026 (“UI26”) states that universities have the role of preparing students for “participation in a democratic society and a diverse economy.” This vision emphasizing the importance of business ethics is shared by many international universities and university associations (e.g., AACSB International, 2009; GMAC, 2012).

Some scholars doubt that universities have succeeded in achieving this vision, especially when it comes to students’ ability to deal with challenging societal issues (Dyck & Schroeder, 2005; Ferraro, Pfeffer, & Sutton, 2005; Ghoshal, 2005; Giacalone & Thompson, 2006; Podolny, 2009). Managers complain universities have not sufficiently prepared students to deal with ethical dilemmas (Bryant, Sigurjonsson, & Mixa, 2018; Sigurjonsson et al., 2014, 2015). Having been students themselves previously, managers often reflect how underequipped they were upon graduation to solve ethical dilemmas (Brown & Treviño, 2006; Mayer, Kuenzi, & Greenbaum, 2010). Universities need to take this challenge seriously. Many authors have argued business schools bear a degree of moral responsibility for unethical decisions taken by their graduates in the corporate world. As a result, many scholars strongly recommend including business ethics and governance education in both graduate and undergraduate programs (Brinkmann, Sims, & Nelson, 2011; Heller & Heller, 2011; Swanson & Fisher, 2008).

Despite agreeing on the need for business ethics and governance education in Iceland, no consensus was reached on how it should be organized and delivered to university students. Theories regarding the role of ethics and governance in business have been around for quite a long time, but during the 2010s, the discourse has become more common in major corporations and academia. These ideas range the gambit – one view perceives business to be unethical at its root while the other view embraces ethics in all facets of the business world. However, many industry experts agree the impact of ethics might be limited in many organizations (Bartlett, 2003; Vaiman, Sigurjonsson, & Davidsson, 2011). The limited impact might be explained by a significant gap between theory and practice in business ethics. Furthermore, some scholars argue the academic field of business ethics does not do a good job of recognizing all the complexities of a contemporary business organization and, therefore, does not provide academics and managers with adequate conceptual and practical frameworks for ethical decision-making (Bowie, 1991, 2000).

Reflecting on these core problems, we concluded the case study research method might be the right solution to our problems at the University of Iceland. Step-by-step, the case method became our primary teaching approach in business ethics and governance courses since students could flex critical thinking skills in real-life situations. One key reference became *Learning with Cases*; a concise book by Mauffette-Leenders, Erskine, and Leenders (2005) that defines a case as, “... a description of an actual situation, commonly involving a decision, a challenge, an opportunity, a problem or an issue faced by a person (or persons) in an organization.” What was particularly attractive for us as business ethics and governance teachers was that “a case allows students to step figuratively into the position of a particular decision maker” (2005, p. 2). We started using cases and immediately saw results since students increased their level of participation, engaging in debate and thinking far beyond “right vs wrong” dilemmas in favour of “right vs right” dilemmas with meaningful nuances.

This book is the culmination of work that started over the last decade. We have compiled 10 case studies which Icelandic business leaders have faced in recent years. The majority of cases deal with challenging decisions after the banking collapse and a number highlight companies grappling with key decisions during COVID-19. Many of the featured organizations have international scope covering industries as diverse as pension funds, airlines, retail, shipping, charities, and biotechnology. We believe all cases are relevant to international students and found natural groupings along the Environmental, Societal, and Governance (ESG) framework.

The case method ties together most of the core principles of our teaching philosophy. A few of these principles or guiding lights deserve special mention. We begin with student-centered learning, which affects all aspects of the course, its content, the role of teacher and student, responsibility for learning, the balance of power in the classroom, and the purpose and process of evaluation. The cases help instructors orient teaching toward student-centered learning. After a few years, we decided to take the additional step of having students participate

in the case writing process, which added a new student-centered dimension to the method.

As part of the course work in both business ethics and governance classes, we assigned the task of researching and writing business cases on a theme relevant to the courses. Students collected data, which in certain situations, involved learning directly from relevant business leaders. This morphed into active student participation in creating course materials for classmates through group participation. According to surveys, students greatly enjoy this aspect of the course. It allows them to reflect on the nature of the learning process itself, just as the case method allows teachers to reflect on their teaching philosophy.

At the same time, we have emphasized the importance of fieldwork for business ethics and governance, in the format of a case study research. Students visit the companies in question, and business leaders and managers are regular guest lecturers in the courses, offering additional insight into these cases. Our adaption of the case method to our situation is also based on a particular philosophical view of the nature of ethical problems and dilemmas. According to one standard view, describing an ethical dilemma is relatively easy, but finding the solution is difficult. As we see it, it is often the other way around. The description of the ethical dilemma or problem is often the most challenging part. In most instances, students know of the company situations from media coverage, which has sometimes been extensive. By working on the cases, students inevitably discover new and subtle aspects of these complex problems. That experience is essential as they become future leaders and managers in the business world.

Through the case study research method, we have increased students' appreciation of the complexities involved in ethics and governance, often teasing out the view of all stakeholders. This is one of the many reasons why we feel it is vital to involve students, especially at the master's level, in case writing. We were impressed with how students took to the task, willing to explore several viewpoints in pursuit of creating class discussion and building knowledge. We have taken the students' initial versions and expanded upon them to meet certain pedagogical objectives. We offer our heartfelt thank you to all of the students who participated in this process.

The case method we have adopted for the Icelandic situation recognizes the interdisciplinary nature of business ethics and governance studies. That is one of the reasons we have organized the book around both of these relatively new and growing fields of study. They complement each other, as both center around decision-making by managers and business leaders.

This book provides two chapters exploring governance and business ethics. We emphasize the interdisciplinary nature of each field of study and how they combine conceptual analyses with empirical studies. Practically minded business leaders and managers will draw on any fields of study which they find helpful, regardless of different university departments (of the authors of this book, one professor is in the business faculty and the other is from the philosophy faculty). We want to ensure university students get the same opportunity to explore multiple fields of study.

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Finally, as a core principle of our teaching philosophy, we should mention our research-based approach. Ultimately, this book is an emerging research project; we hope to build upon in the future as Iceland and the world continue to evolve. We provide students with general and specific business ethics and governance theories in the exploratory chapters. These theories help us formulate the problems dealt with in the cases while providing some insights to working through the cases. However, our main aim has not been to “solve each case” but rather lay a foundation for students to debate, question and formulate their own ideas.

Only then do we feel we will be striving toward our objective of strengthening the understanding of business ethics and governance in Iceland and beyond.

## Chapter 2

# Literature Review

### 2.1 The Development of Corporate Governance

Corporate governance has established itself as an independent field of study in recent decades (Gillan, 2006; Pargendler, 2016). Twenty years ago, the term governance meant little except to a small group of scholars and some shareholders and investors. Today, governance is discussed and dealt with at the level of corporate boards, shareholders, financial regulators, legislators, executives, academics, and those working on public policies (Claessen & Yurtogla, 2012). At the same time, governance has evolved to be interdisciplinary, so that today it covers the fields of business, economics, law, ethics, and sociology. No single definition has received general acceptance (Mallin, 2007). As a result, governance is often viewed from a different perspective.

The definitions of corporate governance used in research are often categorized according to whether they are considered defining the concept broadly or narrowly. In the traditional sense, governance refers to the organization of rights and responsibilities that different stakeholders take when it comes to the operation of a company (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Aoki, 2001). However, there has been a long debate about whether the right role of a company is to maximize the economic gain of shareholders or whether companies play a broader role and have additional responsibilities toward communities in which they operate (Wheeler & Davies, 2004). The first view is in accordance with the notion of shareholders, while the second is in line with the theory of stakeholders. Researchers therefore point to different ideas but focus on fundamental questions related to the definition of the purpose of companies and therefore how to organize governance (Ayuso, Rodríguez, García-Castro, & Ariño, 2014).

The importance of corporate governance has its origins in Berle–Means’ ideology of shareholder ownership and corporate governance in a typical modern company (Berle & Means, 1991). The ownership structure has historically dominated as a reference point for governance. As a result, the main criteria for evaluating good governance are in line with this approach and underlie shareholders’ perspectives, namely the shareholder theory (Wheeler & Davies, 2004). Jensen and Meckling (1976) describe the theory as an agreement in which the principal

(shareholders) grants the agent (manager) the power to perform work on their behalf. Agency problems arise when the principals (shareholders) lack the leverage or information to supervise and control the agent (manager) and/or when the incentives and rewards of both (the principal and the agent) do not go hand in hand.

### *Agency Theory*

The premise of the agency theory is principals and agents have different interests and goals as well as varying access to information. This could result in managers looking after their own interests and behaving in ways that benefit themselves at the expense of shareholders, who then bear the agency costs (Aguilera et al., 2008). When it comes to assessing governance of a company, the responsibilities lie with companies' boards, their CEOs, and other senior executives. Research on the effects of these governance processes and structures, however, are not one-sided (Dalton, Daily, Ellstrand, & Johnson, 1998). Still, research has shown that not only managers but controlling shareholders can infringe on the rights of minority shareholders (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002; Morck, Wolfenzon, & Yeung, 2005). In these cases, both managers and major shareholders are defined as insiders, while minority shareholders and creditors are considered outsiders. In this light, some scholars have criticized the agency theory, which often seeks to explain a direct link between governance and business performance but looks little at other factors that may influence business results (Aguilera et al., 2008; Filatotchev, Jackson, & Nakajima, 2013). Scholars have published research findings that shed light on the way in which governance is influenced by external factors (Aguilera & Jackson, 2010; Weimer & Pape, 1999) and organizational performance is influenced by governance (Aguilera, Florackis, & Kim, 2016; Schiehl, Ahmadjian, & Filatotchev, 2014).

A current approach to corporate governance takes the view that managers should look broadly toward all those who might be impacted by an operation of a company, i.e., more than shareholders (Ayuso et al., 2014). The stakeholder theory, as it is coined, views shareholders as just one of many important stakeholders. According to the theory, managers have an obligation not only to guarantee shareholders a fair return on their investment, but also obligations to other agents and often beyond the narrow definition of law. In this way, governance is organized in such a way to secure the interests of all stakeholders. Research has demonstrated that companies that take this position, one with a broad definition of stakeholders, have shown good financial returns which benefits shareholders (Donaldson & Preston, 1995; Freeman, 1984). Based on this argument, Hill and Jones (1992) propose an agency theory of stakeholders where managers should act as agents of all stakeholders.

In some cases, the interests of different stakeholders' conflict – including shareholders – and thus, need to be reconciled or sacrificed to fulfill basic obligations to other stakeholders. Critics of the theory doubt that it is generally possible to meet the wishes and expectations of all stakeholders and at the same time achieve maximum business success (Coelho, McClure, & Spry, 2003). Similarly, criticism of the theory revolves around the true beneficiaries of a company (Smallman, 2004).

Adherents of the stakeholder theory tend to consider the main stakeholders as employees, suppliers, shareholders, customers, society, governments, and various pressure groups (Coelho et al., 2003). However, several scholars also outline more expansive lists of stakeholders, which Smallman (2004) argues add to the “stereotypical accusation of the ‘sloppiness’ of the theory.” Some scholars emphasize in relation to this, that since the number of stakeholders can be high, it is important to classify them as either major or minor to simplify the arrangement that the board and management must have toward stakeholders.

### *Stakeholder Theory*

Stakeholder theory contains both normative and instrumental implications, since dealing with stakeholders can be understood as a responsibility of meeting the legitimate claims of all stakeholders or to maximize organizational wealth (Donaldson & Preston, 1995; Jones, 1995; Jones & Wicks, 1999). Here, the normative stakeholder theory understands the corporation as a public association that is constituted through political and legal processes and as a social entity for pursuing collective goals with public obligations (Ayuso et al., 2014; Gamble & Kelly, 2001). This implies the company is performing when all stakeholders are satisfied. To appraise the performance of management, it will then be necessary to retain some different indicators reflecting not only on the performance for shareholders, but also the ability to maintain stakeholders’ coalition (Pigé, 2002).

Instrumental stakeholder theory (Donaldson & Preston, 1995; Jones, 1995), on the other hand, legitimizes the value of stakeholders not only based on their intrinsic worth but as an effective way of improving efficiency and profitability. Based on this, instrumental stakeholder theory argues stakeholders, who hold firm-specific investments and bear the operational risks, should take part in corporate decision-making as a means of enhancing corporate efficiency (Blair, 1995; Kelly & Parkinson, 1998). Thus, instead of solely addressing the ethical issues stressed in normative stakeholder theories, the instrumental approach focuses on the achievements that are relevant for performance (Bottenberg, Tuschke, & Flickinger, 2017). Having said that, the instrumental stakeholder theory views the interests of different stakeholders, including shareholders, as largely overlapping because each stakeholder group is dependent on all other stakeholders (Harrison & Wicks, 2013). Understanding corporate governance from this view, a stakeholder-oriented governance setting might not lead firms to suffer from their stakeholder orientation, as is assumed by traditional shareholder-oriented models, but instead ameliorate their competitiveness through constructive stakeholder relations (Bottenberg et al., 2017).

Friedman and Miles (2002) argue stakeholder theory assumes there is a sharp and consistent line between what is considered stakeholder legitimacy and what is considered stakeholder illegality as well as among stakeholders. However, the interests of stakeholders are often incompatible both internally, within a single group and between different stakeholders. Similarly, the relative power of stakeholders, the relationship between the corporation and its stakeholders and the urgent and legitimate stakeholder are in constant flow (Friedman & Miles, 2002;

Mason, Kirkbride & Bryde, 2007). This suggests no single set of rules or models and structures for corporate governance can be sustainable for all companies at all times. That said, research has found improved corporate governance has a positive effect on corporate performance (Bhagat & Bolton, 2008; Gompers, Ishii, & Metrick, 2003).

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) argue the legal system serves as an essential corporate governance mechanism toward the firm. More specifically, they hypothesize the most important factors that affect how corporate governance develops in a particular country is how that country's law protects investors' rights and how the law is enforced. Their results indicate there is a significant difference between countries in terms of the level of investment protection. Denis and McConnell (2003) suggest concentrated ownership may be a response to a lack of investment protection, as owners try to manage situations where the law does not protect them from management. In this situation, La Porta et al. (1998) argue that a conflict between management and shareholders is no longer relevant, as shareholders, due to their concentrated ownership, can control management. Rather, they point out that these circumstances lead to a power conflict between controlling shareholders and minority shareholders.

Corporate governance is grounded in a legal and economic framework that can be reformed through political processes (Shleifer & Vishny, 1997). The main agency problem has been a challenge toward corporate law since the inception of the modern corporation (Hopt, 2011). Efforts to minimize this problem have had limited success, as demonstrated by the increasing number of enacted laws (Bebchuk & Hamdani, 2008; Enriques & Volpin, 2007; Hill, 2004, 2005). A growing number of empirical studies highlight the importance of corporate governance rules for both economic growth and business operations. These studies are most often on national matters (Brennan & Solomon, 2008). They find domestic rules influence cost and supply of capital, financial performance of companies and the distribution of wealth between stakeholders. The literature provides an underlying logic as to why this is the case. First, corporate governance rules aid maximization of social welfare rather than individual investors (Pigou, 1938). The argument is the transfer of wealth between companies caused by increased disclosure causes less damage to the economy than a lack of transparency. Second, corporate governance rules require companies to commit to higher-quality governance (Becht, Bolton, & Röell, 2003). Even when companies design effective policies at one point, they could break them at a later stage.

In general, companies and industries working with stronger legal systems have been found to rely more on external funding to finance their projects (Demirgüç-Kunt & Maksimovic, 1998; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997; Rajan & Zingales, 1998). Furthermore, research shows how stronger investor protection is associated with higher valuations of listed companies (La Porta Lopez-de-Silanes, Shleifer, & Vishny 2002; Wurgler, 2000). As a result of globalization, companies now operate under one set of national rules but compete with international players operating under other sets of national rules (Sachs, 2019). Even though national corporate governance rules often have similar aims (Pistor, Raiser, & Geffer, 2000; Puffer & McCarthy, 2003), companies often face different regulatory costs due