

The Conflict Between Explicit and Implicit Contracts: A Case Study of Wells Fargo and Volkswagen

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Abstract. This paper explores the inherent conflict between explicit and implicit contracts within corporate governance. Separating ownership from control naturally creates information asymmetry and agency conflicts. To align these differing interests, companies usually rely on short-term explicit incentive mechanisms. However, when such performance metrics are overly complex or virtually unattainable, they may induce severe moral hazard. This paper contrasts the Wells Fargo account fraud scandal with the Volkswagen diesel emissions deception. The findings expose a disturbing behavioral pattern where extreme performance mandates essentially force employees into violating foundational implicit contracts. Departing from the traditional dogma of shareholder value maximization, critical necessity is indicated. Companies must reconcile their explicit incentives with implicit ethical governance. Taking this step prevents moral hazard and ensures sustainable enterprise value creation.

Keywords: Agency Problem, Explicit Contract, Moral Hazard, Shareholder Value, Corporate Governance

1. Introduction

The separation of ownership and control constitutes the absolute cornerstone of modern listed companies. This structural reality has established a complex agency relationship between shareholders and managers [1]. Since signing contracts in a dynamic business environment is always inherently incomplete, the corporate governance framework largely depends on maintaining a fragile balance. The company must carefully balance explicit contracts and implicit contracts. A contract provides formal, legally enforceable and result oriented instructions. In contrast, implicit explicit contracts consist of unwritten, legally unenforceable ethical commitments that set normative boundaries for acceptable organizational conduct within firms [2].

This leads to a crucial research question: will employees systematically violate implicit contracts out of the need to pursue measurable and clear goals? The results show that when executives set extremely strict performance targets, they may inadvertently trigger catastrophic systemic moral hazard. To clarify this point, two severe corporate failure cases have been investigated. This paper conducts a detailed analysis of the Wells Fargo retail fake account scandal and the Volkswagen diesel emissions scandal.

This analysis fills an important gap in the field of corporate governance research. It critiques the shareholder value maximization paradigm from the perspectives of employee conduct and financial metric evaluation. In the end, this study put forward some urgent and practical warnings. Modern enterprises need to be extremely cautious in building an institutional framework that matches their incentive mechanism. Failure to achieve this may inadvertently destroy a firm's fundamental moral standards.

2. Agency problem and contractual conflict

2.1. Separation of ownership and control, information asymmetry and moral hazard

Agency theory provides us with the theoretical basis for modern corporate governance. It views the firm as a nexus of contracts formed among self-interested rational participants [1]. The agency problem occurs precisely because the principal gives the operating rights to the agent. The personal utility functions of these agents are rarely fully consistent with the principal's ultimate goal of maximising wealth [1]. As shareholders cannot fully observe or monitor agents' daily behaviours, persistent information asymmetry permeates corporate operational environments. This information gap provides fertile breeding ground for moral hazard. Agents may take unnecessary risks, take shortcuts or take speculative behaviour because they know that the potential negative consequences or long-term costs mainly fall on the principal rather than themselves [2].

In order to eliminate this gap, the board of directors will design a governance mechanism and a structured incentive contract [1]. Surprisingly, the design of these compensation structures often changes from a simple solution to a core component of the agency problem itself [3]. Executives with significant structural power tend to influence their own compensation arrangements, resulting in compensation structures that are highly sensitive to short-term manipulable metrics [3]. As the stock market continues to force executives to achieve immediate financial returns, these executives will pass the pressure down to the organisational hierarchy. They set strict operational goals for middle-level managers and front-line employees, laying the foundation for deep contract conflicts.

2.2. The boundaries and contradictions of explicit and implicit contracts

Contract theory relies on the mixed form of explicit contract and implicit contract to regulate the relationship between the principal and the agent [2]. Explicit contracts function as formal written agreements that establish verifiable performance metrics and financial incentive schemes, characterized by quantifiability, ease of monitoring, and structural enforceability [2]. Implicit contracts, also known as relational contracts, bear the common corporate values and moral bottom lines, mainly regulating difficult-to-quantify operational behaviours such as maintaining brand reputation, honest service, and lawful operation. They rely on the value of continuous relationship and corporate reputation capital to realise self-enforcement [2].

The multitask agency problem explains the internal contradictions between these two types of contracts from a mathematical perspective [4]. Corporate operations include multiple tasks that are quantifiable and difficult to measure in the short term. If strong financial incentives are applied only to explicit assessment tasks, agents will one-sidedly pursue quantifiable indicators and ignore implicit contract constraints. When explicit performance goals are decoupled from reality and impossible to achieve, agents will weigh the pros and cons and actively abandon implicit contracts, triggering systematic unethical behaviour [2].

At the same time, firms with a highly concentrated ownership structure face a secondary agency problem between controlling shareholders and minority shareholders. Volkswagen's voting shares are highly concentrated. The controlling family and regional shareholders lead the business strategy and ignore the demands of minority shareholders. After the emission scandal occurred, the loss was mainly borne by minority shareholders, which highlighted the governance hidden danger brought by the unbalanced ownership structure [5].

3. How explicit incentives induce moral hazard: case analyses

Wells Fargo has long relied on a cross-selling strategy for its development, using "Eight is Great" as a rigid performance indicator to force employees to promote multiple financial products to existing customers [6]. This strategy evolved into a high-pressure explicit contract assessment, where employees' compensation, performance, and basic job security were completely tied to unrealistic sales targets; supervisors applied intense pressure, and failing to meet targets meant facing immediate dismissal. From the perspective of multitask principal-agent theory, employees breached the implicit contractual norm of honest service to fulfil explicit performance requirements, engaged in systematic fraudulent conduct, illegally opened approximately 3.5 million unauthorized accounts, and misled customers via practices including secret password setting (pinning) and tied selling [6, 7]. Coupled with the failure of corporate governance and board supervision, as well as departments closing themselves off to protect themselves and conceal the chaos, Wells Fargo was ultimately fined \$185 million and dismissed 5,300 employees [7]. Similarly, Volkswagen launched the "2018 Strategy", setting an aggressive explicit target of producing 10 million cars annually and overtaking Toyota [5]. In order to expand into the U.S. market, its self-developed diesel engines faced strict U.S. environmental emission standards [8]. Rigid R&D targets detached from engineering reality and a hierarchical high-pressure culture forced engineers to break the implicit contract of compliance and environmental protection, developing cheating software to tamper with emission test data, resulting in about 11 million vehicles worldwide exceeding emissions up to 40 times the legal limit [5, 8]. This fraud ultimately cost Volkswagen over \$20 billion in fines and compensation, highlighting that strict explicit assessments in the manufacturing industry can also trigger severe moral hazard.

4. Critical reflection on the concept of maximising shareholder value

The catastrophic governance mistakes of Wells Fargo and Volkswagen are not isolated and abnormal events. On the contrary, they represent extreme manifestations of systemic flaws inherent in modern corporate governance paradigms, indicating that the indiscriminate and rigid pursuit of shareholder value maximization poses significant risks.

4.1. Macro-explicit contract: the microstructure of the financial market

It is true that it is too superficial to simply blame the greed of executives. It is necessary to take a step back and examine the broader microstructure of the financial market. The modern capital market has built a huge and invisible macro-explicit contract. The surge in passive index funds, which is now dominating global stock ownership, has fundamentally changed the way companies operate, shifting the focus to strict compliance with benchmark standards [9]. At the same time, high-frequency algorithm trading requires instant financial results, thus creating a highly reactive environment. Even the slightest deviation in profits can trigger automated large-scale sell-offs [9].

Surprisingly, when executives impose stringent internal performance targets, their motivation is not merely personal greed. In fact, they are making a rational and defensive response to this ruthless external pressure. The final collapse of the internal implicit moral contract is actually just a micro-embodiment of these deep-seated structural defects in the broader capital market. Real reform means repairing the structure of the market, not just firing a few underperforming managers.

4.2. Financial quantitative perspective: standardisation of quantitative financial model

It is impossible to fully understand the actual situation just by focussing on the initial regulatory punishment. A comprehensive understanding of the catastrophic structural damage resulting from the breach of implicit contracts requires a rigorous financial quantitative lens. When extreme moral hazard are exposed, it fundamentally undermines the risk situation of the enterprise. This destruction can be concretised through an analysis of the econometric foundations of the capital asset pricing model.

The standard expected return is determined by the following formula:

$$E(R_i) = R_f + \beta_i(E(R_m) - R_f) \quad (1)$$

To estimate this risk premium, analysts rely on the single-index market model regression equation:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it} \quad (2)$$

For Volkswagen, the diesel emissions scandal triggered a catastrophic breakdown of these fundamental equations. During this extreme implicit contract crisis, the variance of the regression error term $\text{Var}(\varepsilon_{it})$, representing pure idiosyncratic firm risk experienced an exponential non-linear expansion [10]. Concurrently, panic-driven indiscriminate selling caused the covariance between the asset return and the market benchmark $\text{Cov}(R_{it}, R_{mt})$ to sharply contract. Because the beta coefficient is mathematically defined as $\beta_i = \frac{\text{Cov}(R_{it}, R_{mt})}{\text{Var}(R_{mt})}$, these two colliding forces caused Volkswagen's calculated β value to rapidly approach zero and lose statistical significance [10]. As noted by Čižinská, Matějková, and Neset, the Dieselgate scandal proves that the reliability of beta estimates is an inverse function of market volatility, rendering historical market beta a poor estimate of the required rate of return [10]. Future empirical research should utilize rolling window regression analysis to dynamically track this beta decay and structural decoupling. However, mechanically applying this near-zero β to the CAPM formula yields an paradoxically low expected return that approaches the risk-free rate, creating a profound theoretical contradiction. This exposes a fundamental limitation of traditional asset pricing during extreme corporate governance crises: pure systematic risk (β) models completely fail to capture the true cost of capital when a firm faces existential legal and fraud threats. When catastrophic moral hazard is exposed, idiosyncratic risk explodes to a level that threatens the firm's going concern. In such extreme distress, market investors can no longer diversify this risk away and strictly demand a massive idiosyncratic risk premium. Furthermore, standard linear asset pricing breaks down, forcing the market to intuitively shift toward structural credit risk frameworks, such as the Merton Model. Under this perspective, corporate equity is effectively priced as a call option on the firm's underlying assets, with the strike price equal to its outstanding debt obligations. The exponential surge in pure idiosyncratic volatility—driven by unpredictable, multi-billion-dollar regulatory fines—dramatically inflates the structural probability

of default. This explosive risk premium is what truly drives up the cost of capital, which heavily discounts the firm's future cash flows and instantly erodes shareholder value.

For Wells Fargo, the real financial disaster began in 2018 when the Federal Reserve implemented an unprecedented \$1.95 trillion asset ceiling. This strict regulatory constraint effectively froze the bank's balance sheet for seven years, forcing it to abandon its profitable commercial lending business, while competitors expanded rapidly. Analysts estimate that this structural paralysis eventually caused Wells Fargo to lose up to \$39 billion in potential profits [11]. In order to bear these astronomical fines and higher capital costs, executives usually adopt the means of manipulating actual activities [12]. Driven by survival panic, the leadership team has drastically cut key long-term investments, especially the R&D budget and employee welfare. Fines arising from ethical violations eventually force enterprises to encroach on the financial structure necessary to maintain long-term enterprise value.

4.3. Shareholder value; a result or a strategy

The mainstream institutional logic believes that the only legitimate goal of a company is to maximise financial returns for shareholders. It can be said that some famous academic views are increasingly emphasising that there is a serious logical error in the blind application of this theory. Michael Jensen put forward a fundamental difference. He argues that value maximization is merely an outcome serving as a scorecard, rather than a strategy that provides a long-term developmental vision [1]. The total market value of a long-term company is a good scoring criterion because it clearly tells participants how success will be evaluated. However, there is no information provided to participants about how to actually create value, and there is no guidance on creating excellent products, recruiting talents or treating customers [1]. Boards often confuse scoring cards with strategies, which inevitably leads them to focus only on the management of high profile and short term financial indicators.

Lynn Stout, a legal scholar, further elaborated on this view in the book *The Shareholder Value Myth*. Stout pointed out that the unremitting pursuit of realising shareholder value often destroys human and material capital. Executives are strongly incentivized to exploit employees, slash R&D spending, and relax ethical standards to drive short-term stock price appreciation [13]. In the end, the creed of shareholder supremacy actually favours the most speculative and self-destructive short-term speculators, resulting in wealth transfer at the expense of the interests of long-term investors, employees and society.

Alex Edmans put forward a different point of view in the book *"Grow the Pie"*. He believes that social values and shareholder profits are not a zero-sum game relationship [14]. The most successful companies rarely pursue profits directly; instead, they are driven by a core mission: to serve societal needs. Wells Fargo and Volkswagen regard profit and market dominance as direct and clear strategies. This fundamental mistake forces employees to participate in the behaviour of dividing the cake - a destructive process involving the extraction and fraud of value, rather than real value creation [14].

5. Governance strategy to mitigate contract conflicts

Corporate governance cannot over-rely on rigid explicit incentives. The board of directors should build a comprehensive institutional framework that balances explicit performance goals with implicit ethical norms, and view the dual effects of various governance measures dialectically. First of all, enterprises need to reconstruct their performance evaluation system, combining quantitative

indicators with subjective evaluation to curb fraudulent behaviour [4]. However, subjective assessment is highly vulnerable to manager bias and discretion, exhibiting spillover effects and asymmetrical adjustment characteristics. Departments may also shield violating employees out of self-interest, artificially inflating ethical scores and weakening governance effectiveness [15]. Secondly, it is necessary to reform the decentralised organisational model. Drawing on the governance lessons from Wells Fargo, risk management authority should be centralized to ensure unobstructed information flow [7]. Yet, excessive centralisation can lead to a rigid compliance mechanism and a disconnect between business operations and risk control, causing front-line employees to resist risk management requirements. Finally, compensation clawback provisions should be used rationally. While this mechanism can suppress financial misstatements [16], overly strict policies will force management to shift towards real earnings management. They may artificially inflate short-term performance by slashing R&D and marketing expenditures [12], ultimately undermining firms' long-term innovation capacity and sustainable development potential.

6. Propose a normative governance framework: regulatory technology and design-based compliance architecture

Simply pointing out the shortcomings of existing governance tools is still a relatively passive measure; corporate governance should shift from problem diagnosis to top-level architectural design to prevent moral hazard from the source. Enterprises should leverage regulatory technology, like RegTech, to implement a compliance-by-design governance model, embedding automated regulatory compliance directly into business processes to reduce the bias and collusion risks caused by human subjective judgement [17]. A completely independent compliance department must be established, where the chief compliance officer reports directly to the board of directors or the independent audit committee, free from management interference, and is granted absolute veto power over executive compensation. At the same time, a data-driven performance evaluation model should be adopted. Relying on big data algorithms to comprehensively analyse information such as compliance logs, employee replacement rates, and whistleblower reports, this model strips away financial performance interference to objectively evaluate ethical fulfilment. By integrating blockchain-enabled audit tracing, compliance decisions and ethical assessments can be permanently recorded on a tamper-proof ledger [18], enabling the separation and independent evaluation of explicit performance indicators and implicit ethical norms, and transforming corporate governance from passive ex-post sanctions to proactive ex-ante prevention.

7. Conclusion

Using the Wells Fargo account fraud and the Volkswagen emissions scandal as case studies, this paper examines the problem of incentive misalignment within the traditional principal-agent framework. The core conclusion is that over-reliance on short-term explicit performance indicators essentially forces employees to abandon implicit contracts; when coupled with a toxic corporate culture, this easily triggers catastrophic moral hazard. Enterprises must abandon the single-minded concept of maximizing shareholder value, balance explicit incentives with implicit ethics, and rely on a compliance-by-design architecture to neutralize the negative side effects of incentives. This study is limited to two large multinational corporations embroiled in high-profile scandals, which restricts the generalizability of its findings. Future research should shift towards the integration of quantitative methods and technology to measure the critical point at which explicit incentives erode

implicit contracts, construct a quantitative framework, and establish a decentralized audit architecture. Concurrently, the limitations of technological governance must be viewed rationally.

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