

# ETHICS AND THE CONDUCT OF BUSINESS

EIGHTH EDITION



JOHN R. BOATRIGHT | JEFFREY SMITH

# Ethics and the Conduct of Business

Eighth Edition

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# Preface

The eighth edition of *Ethics and the Conduct of Business* has reached two significant milestones. The first achievement, which is obvious to anyone reading these words, is the transition to digital media. Through Pearson's online platform REVEL, this text offers not only a new mobile reading experience—on computers, tablets, and even smartphones—but also a new approach to learning, with many interactive features, videos, quizzes, and other educational tools. REVEL creates a new frontier in education for both students and instructors. It is exciting for us, as authors, to be pioneer participants in this promising and innovative endeavor.

Users of previous editions will also note the appearance of a coauthor, Jeffery D. Smith. His collaboration in the eighth edition not only brings a fresh perspective to what is now a joint venture but also prepares for the future of this classic text, which first appeared more than 20 years ago. Under Jeffery's guidance, *Ethics and the Conduct of Business* will hopefully continue to remain current and relevant through many new editions.

The eight editions of *Ethics and the Conduct of Business* have followed the development of the field of business ethics, which has grown in recent decades into an interdisciplinary area of study that has found a secure niche in both liberal arts and business education. Credit for this development belongs to many individuals—both philosophers and business scholars—who have succeeded in relating ethical theory to the various problems of ethics that arise in business. They have shown not only that business is a fruitful subject for philosophical exploration but also that future managers in the world of business can benefit from the results.

*Ethics and the Conduct of Business*, eighth edition, is a comprehensive and up-to-date discussion of the most prominent issues in the field of business ethics and the major positions and arguments on these issues. It is intended to be used as a text in business ethics courses on either the undergraduate or M.B.A. level. The substantial number of cases included provides ample opportunity for a case-study approach or a combined lecture–discussion format. There has been no attempt to develop a distinctive ethical system or to argue for specific conclusions. The field of business ethics is marked by reasonable disagreement that should be reflected in any good text for a course.

The focus of *Ethics and the Conduct of Business* is primarily on ethical issues that corporate decision makers face in developing policies about employees, customers, investors, and the general public. The positions on these

issues and the arguments for them are taken from a wide variety of sources, including economics and the law. The study of ethical issues in business is not confined to a single academic discipline or even to the academic world. The issues selected for discussion are widely debated by legislators, judges, government regulators, business leaders, journalists, and, indeed, virtually everyone with an interest in business.

An underlying assumption of this course is that ethical theory is essential for a full understanding of the positions and arguments offered on the main issues in business ethics. Fortunately, the amount of theory needed is relatively small, and much of the discussion of these issues can be understood apart from the theoretical foundation provided here. The text also contains a substantial amount of legal material, not only because the law addresses many ethical issues but also because management decision making must take account of the relevant law. Many examples are used throughout the text in order to explain points and show the relevance of the discussion to real-life business practice.

## New to the Edition

Preparation of the eighth edition of *Ethics and the Conduct of Business* has provided an opportunity to incorporate new developments and to increase its value in the classroom. The major changes from the previous edition are as follows:

- Chapter 5 on business information has been expanded to provide greater coverage on confidential information and the duty of confidentiality.
- Chapter 6 on privacy has been expanded to include more on the protection of both employee and consumer privacy against intrusions, especially from advances in technology.
- The section on product safety has been moved from Chapter 10 on marketing and advertising to the coverage of worker health and safety in Chapter 9. This change has allowed expanded treatment in Chapter 10 of emerging issues in marketing and advertising, especially those related to the use of social media and data analysis, which have been facilitated by the Internet.
- Chapter 12 on corporate social responsibility includes a new section on the recent development of for-profit businesses, known as social enterprises, which operate with a mission to deliver vital social services.

- The Chapter 13 section on corporate governance has been completely rewritten for greater clarity and coherence.
- The eighth edition contains 58 short cases, including 12 new ones on such subjects as a falsified résumé at Yahoo, conflict of interest at Goldman Sachs, a firing at Google for blogging, profiling of Internet visitors by a major bank, variable pricing strategies in grocery stores, Herbalife's unusual multilevel marketing scheme, Coca-Cola's water use in India, and bribery by Walmart executives in Mexico.

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I, John Boatright, am grateful for the support of Loyola University Chicago and especially the Quinlan School of Business. I have benefited from the resources of the Raymond C. Baumhart, S.J., Chair in Business Ethics, which was created to honor a former president of Loyola University Chicago, who was also a pioneer in the field of business ethics. To Ray Baumhart I owe a special debt of gratitude. I am grateful as well to Jeffery Smith for graciously accepting my offer to become a coauthor of this edition and my ultimate successor in the preparation of future editions. Finally, my deepest expression of appreciation goes to my wife, Claudia, whose affection, patience, and support have been essential for the preparation of the eighth edition, as they were for the ones previous.

It goes without saying that I, Jeffery Smith, am excited to work with John Boatright on this important project and appreciate his generous offer to continue our collaboration on future editions. I hope to maintain the clarity, depth, and even-handedness that have made earlier editions so valuable to students and instructors. For over a decade, I

have benefited from the support of the Banta Center for Business, Ethics and Society and my colleagues at the University of Redlands. For everyone there I am grateful. My thanks also go to DePauw University's Prindle Institute for Ethics for hosting me as the Nancy Schaenen Visiting Scholar while portions of the eighth edition were written. And I also owe so much to my lovely wife, Rita, who provides support when I need it most and continues to keep me grounded.

John R. Boatright

Jeffery D. Smith

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# Chapter 1

# Ethics in the World of Business



## Learning Objectives

- 1.1 Identify ethical issues created by diverse business situations and relationships and the level of decision making required to address them
- 1.2 Recognize the role of ethics in the conduct of business, with respect to economic principles and the law
- 1.3 Distinguish between ethical management and the management of ethics, and each of the three main roles of a manager
- 1.4 Analyze how ethical business conduct is challenged by decision making on individual and organizational levels

## Case: Merck and the Marketing of Vioxx

On September 30, 2004, Merck & Co. announced the withdrawal of Vioxx, its highly profitable pain reliever for arthritis sufferers, from the market.<sup>1</sup> This announcement came only seven days after company researchers found in a clinical trial that subjects who used Vioxx more than 18 months had a substantially higher incidence of heart attacks. Merck chairman and CEO Raymond V. Gilmartin described the action as “the responsible thing to do.” He explained, “It’s built into the principles of the company to think in this fashion. That’s why the management team came to such an easy conclusion.”<sup>2</sup> In the lawsuits that followed, however, damaging documents emerged casting doubt on Merck’s claim that it had acted responsibly by taking appropriate precautions in the development and marketing of the drug.

### Development of Vioxx

For decades, Merck’s stellar reputation rested on the company’s emphasis on science-driven research and development. Merck employed some of the world’s most talented and best-paid researchers and led other pharmaceutical firms in the publication of scientific articles and the discovery of new medicines for the treatment of serious conditions that lacked satisfactory therapies. For seven consecutive years in the 1980s, Merck was ranked by *Fortune* magazine as America’s most respected company. Merck received widespread accolades in particular for the decision, made in 1978, to proceed with research on a drug for preventing river blindness (onchocerciasis), which is a debilitating

parasite infection that afflicts many in Africa, even though the drug was unlikely to pay for itself. Eventually, Merck decided to give away the drug, called Mectizan, for as long as necessary at a cost of tens of millions of dollars per year. This kind of principled decision making was inspired by the words of George W. Merck, the son of the company’s founder: “We try never to forget that medicine is for the people. It is not for the profits. The profits follow, and if we have remembered that, they have never failed to appear. The better we have remembered it, the larger they have been.”

Vioxx is an example of Merck’s innovative research. Developed as a treatment for the pain of arthritis, the drug acts as an anti-inflammatory by suppressing an enzyme responsible for arthritis pain. Other drugs in the class of nonsteroidal anti-inflammatory drugs (NSAIDs) inhibit the production of two enzymes COX-1 and COX-2. However, COX-1 is important for protecting the stomach lining, and so ulcers and stomach bleeding are potential side effects of these drugs. The distinctive benefit of Vioxx over other NSAID pain relievers, such as ibuprofen (Advil) and naproxen (Aleve), is that it inhibits the production of only the COX-2 enzyme, and not COX-1. After approval by the Food and Drug Administration (FDA) in May 1999, Vioxx quickly became a popular best seller. More than 20 million people took Vioxx between 1999 and 2004, and at the time of the withdrawal, with 2 million users, Merck was earning \$2.5 billion annually or 11 percent of the company’s total revenues from the sale of the drug.

### Competitive Environment

The success of Vioxx came at a critical time for Merck. Not only were the patents on several profitable drugs due to expire, opening the way for generic competition, but also the competitive

environment of the entire pharmaceutical industry was undergoing rapid change. Competition from generic drugs increased dramatically due to federal legislation and also due to the rise of large, powerful managed care organizations, which sought to cut the cost of drug treatments through the use of formularies that restricted the drugs doctors could prescribe. The development of new drugs was increasingly shifting to small entrepreneurial research companies focused on specific technologies, which reduced the competitive advantage of the traditional large pharmaceutical firms. Merck's competitors responded to changes in the competitive environment by acquiring small companies, developing new products that duplicated ones already on the market (so-called "me-too" drugs), entering the generics market, seeking extensions of patents after making only slight improvements, and engaging in aggressive marketing, including the use of controversial direct-to-consumer (DTC) advertising.

The first four strategies—growth by acquisition, the development of "me-too" drugs, the production of generics, and making improvements merely to extend patents—conflicted with Merck's culture and values. However, under the previous CEO, Roy Vagelos (who guided Merck through the development of Mectizan for river blindness), the company greatly increased its emphasis on marketing. This increase in emphasis was considered necessary given the short time available to sell a drug before the patent expired. In particular, evidence was needed not only to prove a product's safety and effectiveness in order to gain FDA approval but also to persuade physicians to prescribe it instead of the competitors' medications. Since much of the information that could persuade doctors was part of a drug's label, marketers needed to be involved in the development of a product from the earliest research stages in order to prepare a persuasive label. The label could be improved further by conducting tests, which were not scientifically necessary but which generated clinically proven results that could be useful in persuading physicians. Under Gilmartin, the company's formally stated strategy became: "Turning cutting-edge science into novel medicines that are true advances in patient care with proven clinical outcomes."

### Decision to Withdraw

In announcing the withdrawal of Vioxx, Gilmartin described the evidence of increased risk of heart attacks as "unexpected." In the first lawsuits against Merck that came to trial, evidence was presented to show that company scientists had considered the potential heart problems with Vioxx as early as 1997. The first hint of trouble came in that year as Merck scientists noticed that Vioxx appeared to suppress the production of a substance in the body that acted naturally to reduce the incidence of heart attacks. Although the significance of this discovery was recognized, no follow-up investigations were undertaken.

More significant evidence that Vioxx might contribute to heart attacks was produced by a study concluded in 2000 that was designed to compare the gastrointestinal effects of Vioxx and naproxen in order to improve the label of the Merck product by proving that Vioxx was less harmful to the stomach lining. Although the study, called VIGOR (for Vioxx Gastrointestinal Outcomes Research), showed that Vioxx users had heart attacks at a rate four to five times that of the naproxen group, researchers were uncertain whether the difference was due to an adverse effect of Vioxx in causing heart attacks or a beneficial effect of naproxen in preventing them. The heart attacks in the trial occurred mainly in the Vioxx subjects who were already at greatest risk of heart attacks, and all subjects were prohibited from taking aspirin (which is known to prevent heart attacks) in order to gain reliable results from the study since aspirin affects the stomach. When the results of the VIGOR study were published in the November 2000 issue of the prestigious *New England Journal of Medicine*, the beneficial effects of naproxen were emphasized in a way that implied that Vioxx was safe for people without the risk factors for heart attacks. After initially resisting pressure by the FDA to include a warning on the Vioxx label, Merck finally agreed in April 2002 to add the evidence of an increased incidence of heart attacks. However, the language on the label emphasized, again, the uncertainty of the cause and recommended that people at risk of heart attacks continue to use an anti-inflammatory for protection.

In the meantime, Merck continued its aggressive marketing campaign. Between 1999 and 2004, Merck spent more than \$500 million on DTC television and print advertising. This expenditure was intended to keep pace with the heavy spending by Pfizer for its competing COX-2 inhibitor Celebrex. Merck also maintained a 3,000-person sales force to meet with doctors for face-to-face conversations about Vioxx. To support this effort, Merck developed materials that provided salespeople with responses to questions from skeptical physicians.<sup>3</sup> One document, called an "obstacle handling guide," advised that questions about the risk of heart attacks be answered with the evasive explanations that Vioxx "would not be expected to demonstrate reductions" in heart attacks and was "not a substitute for aspirin." Another document titled "Dodge Ball Vioxx" concluded with four pages that were blank except for the word "DODGE!" in capital letters on each page. Company documents also describe an effort to "neutralize" skeptical doctors by enlisting their support or at least defusing their opposition by offers of research support or engagements as consultants.<sup>4</sup>

The timeline below outlines key events in the development, approval, and marketing of Vioxx and the outcome for Merck.

### The History of Vioxx

The Food and Drug Administration (FDA) has a multi-phase approval process to evaluate the testing, safety, and labeling of all new prescription drugs to be sold in the United States. The FDA also monitors the "post-marketing" safety of approved drugs, to ensure that the public is informed of any new health risks that are revealed by widespread use and additional studies.

## Timeline

<b>December 1994</b>	Merck seeks FDA approval to begin Vioxx clinical trials (on human subjects), based on the success of animal testing.
<b>1997</b>	Merck scientists discover the first signs that Vioxx may cause cardiovascular problems.
<b>November 1998</b>	Merck applies for FDA approval to market Vioxx for the treatment of acute pain, dysmenorrhea (menstrual cramps), and osteoarthritis. The application includes the results of about 60 studies, none of which points to potential cardiovascular risks.
<b>January 1999</b>	Merck begins the Vioxx Gastrointestinal Outcomes Research study (VIGOR) to determine whether Vioxx is safer for the digestive system than naproxen, an older painkiller. This later becomes a key selling point for the drug.
<b>May 1999</b>	After a six-month review, the FDA approves Vioxx for the three uses Merck specified in its application.
<b>October 1999 – December 1999</b>	The data and safety monitoring board for Merck's VIGOR study meets several times to discuss its findings. Although Vioxx appears to increase the risk of heart problems in test subjects, the board votes to continue the study and keep marketing Vioxx to the public.
<b>November 2000</b>	Merck's VIGOR study is published in the <i>New England Journal of Medicine</i> , but Merck does not include all observed instances of heart attacks and downplays the cardiovascular risks.
<b>2001</b>	The FDA publishes the full VIGOR study results and additional studies conducted by independent parties also indicate that there is a real risk of cardiovascular problems. In September, the FDA warns Merck that the Vioxx marketing campaign and label do not adequately represent its health risks.
<b>April 2002</b>	Merck changes the drug's label to better reflect the dangers and necessary precautions for prescribing doctors and users, based on the VIGOR study. The FDA also approves Vioxx for an additional use: the treatment of rheumatoid arthritis.
<b>September 2004</b>	Merck's APPROVe (Adenomatous Polyp Prevention on Vioxx) study conclusively shows that Vioxx increases the risk of heart attacks and strokes after 18 months of treatment. Merck then voluntarily stops the sale of Vioxx.
<b>January 2005</b>	A British medical journal publishes a study that estimates Vioxx caused heart attacks in 88,000–140,000 Americans and fatal heart attacks in 38,000. Study author David Graham is an FDA scientist who also affirmed the correlation between Vioxx and heart attacks in his earlier testimony to Congress.
<b>November 2007</b>	After facing multiple lawsuits, Merck agrees to pay \$4.85 billion to settle about 47,000 personal injury claims from former Vioxx users.
<b>December 2011</b>	Merck pleads guilty to promoting Vioxx as a treatment for rheumatoid arthritis before it received FDA approval for this use in 2002. The company agrees to pay a fine of \$628 million in the civil settlement.
<b>April 2012</b>	A U.S. district court orders Merck to pay an additional \$322 million as a criminal penalty for its misleading promotion and marketing of Vioxx.

Additional sources: "Sequence of Events with VIOXX, Since Opening of IND," U.S. FDA Advisory Committees Briefing, 9 April 2005; Snigdha Prakash and Vikki Valentine, "Timeline: The Rise and Fall of Vioxx," National Public Radio, 10 November 2007; "U.S. Pharmaceutical Company Merck Sharp & Dohme Sentenced in Connection with Unlawful Promotion of Vioxx," U.S. Department of Justice Press Release, 19 April 2012.



### Criticisms and Defenses

The study that conclusively established that Vioxx increased the risk of heart attacks was called APPROVe (Adenomatous Polyp Prevention on Vioxx), which, according to critics, had only a marketing and not a legitimate scientific purpose.<sup>5</sup> Although the company could have delayed the withdrawal until ordered to do so by the FDA, Merck acted voluntarily. Gilmartin said that the company “was really putting patient safety first.”<sup>6</sup> However, one critic replied, “If Merck were truly acting in the interest of the public, of course, they should have done more studies on Vioxx’s safety when doubts about it first surfaced.”<sup>7</sup> Another critic observed that such studies could have been conducted for a fraction of the cost of the \$500 million spent on advertising.<sup>8</sup>

An editorial in the *New York Times* declared that “companies must jump at the first hint of risk and warn patients and doctors of any dangers as clearly and quickly as possible. They should not be stonewalling regulators, soft-pedaling risk to doctors or promoting drugs to millions of people who don’t need them.”<sup>9</sup> A 179-page report commissioned by the Merck board concluded, by contrast, that executives and researchers acted with integrity in addressing incomplete and conflicting evidence and that “their conclusions were reached in good faith and were reasonable under the circumstances.”<sup>10</sup> The report closed with the observation that the quick response after the APPROVe study “is not consistent with the view that Merck’s corporate culture put profits over patient safety.”<sup>11</sup>

## Points to Consider...

The Vioxx crisis was an unusually difficult and damaging experience for Merck, which has both a history of responsible conduct and a commitment to the highest standards of ethics. Although Merck’s culture is built on strong values, these were not enough to prevent a series of decisions that, right or wrong, seriously damaged the company’s carefully built reputation. Merck executives appear to have considered carefully the possible health risk posed by Vioxx, and yet the push for profits may have led them to conclude too easily that Vioxx was not the cause of the heart attacks suffered by test subjects and that further studies were not necessary. The increased role of marketing, including heavy consumer advertising, in a traditionally science-driven culture was probably a factor in whatever mistakes were made, as was the change in strategy to seek evidence of the products’ superiority as part of a marketing campaign to influence physicians. However, Merck’s strategy could not have avoided some adjustment given the changed competitive environment that was created by forces outside the company’s control.

All business organizations face the daunting challenge of adhering to the highest standards of ethics while, at the same time, remaining competitive and providing the products and services that the public demands. The task of managers in these organizations is to make sound business decisions that enable a company to achieve its mission. Some of these decisions involve complex ethical issues that may not be readily apparent, and success in making sound business decisions may depend on understanding these ethical issues and resolving them effectively. Ethical issues are considered by managers in the ordinary course of their work, but they are also matters that are discussed in the pages of the business press, debated in the halls of Congress, and scrutinized by the courts. This public concern arises because ethical issues in business are closely tied to important matters of public policy and to the legislative, administrative, and judicial processes of government.

These ethical issues are often only part of a complex set of challenges facing the whole of society.

### WRITING PROMPT

#### Decisions by Multiple Parties

After Vioxx was taken off the market, Congress began investigating the effectiveness and integrity of the FDA’s drug approval process along with Merck’s own actions. What are the costs and benefits of approving new drugs for sale as quickly as possible? Why might the FDA be reluctant to acknowledge a problem with, or recall, a drug that it had previously approved?

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## 1.1: Business Decision Making

### 1.1 Identify ethical issues created by diverse business situations and relationships and the level of decision making required to address them

Although ethical issues in business are very diverse, the following examples provide a useful starting point.

#### 1. *The Sales Rep*

A sales representative for a struggling computer supply firm has a chance to close a multimillion-dollar deal for an office system to be installed over a two-year period. The machines for the first delivery are in the company’s warehouse, but the remainder would have to be ordered from the manufacturer. Because the manufacturer is having difficulty meeting the heavy demand for the popular model, the sales representative is not sure that subsequent deliveries can be made on time. Any delay in converting to the new system would be costly to the customer; however, the blame could be placed on the manufacturer.

**Ethical Issue:** Should the sales representative close the deal without advising the customer of the delivery problem?

## 2. *The Research Director*

The director of research in a large aerospace firm recently promoted a woman to head an engineering team charged with designing a critical component for a new plane. She was tapped for the job because of her superior knowledge of the engineering aspects of the project, but the men under her direction have been expressing resentment at working for a woman by subtly sabotaging the work of the team. The director believes that it is unfair to deprive the woman of advancement merely because of the prejudice of her male colleagues, but quick completion of the designs and the building of a prototype are vital to the success of the company.

**Ethical Issue:** Should the director remove the woman as head of the engineering team?

## 3. *The Marketing Director*

The vice president of marketing for a major brewing company is aware that college students account for a large proportion of beer sales and that people in this age group form lifelong loyalties to particular brands of beer. The executive is personally uncomfortable with the tasteless gimmicks used by her competitors in the industry to encourage drinking on campuses, including beach parties and beer-drinking contests. She worries about the company's contribution to underage drinking and alcohol abuse among college students.

**Ethical Issue:** Should the marketing director follow the competition's troubling practices?

## 4. *The CEO*

The CEO of a midsize producer of a popular line of kitchen appliances is approached about merging with a larger company. The terms offered by the suitor are very advantageous to the CEO, who would receive a large severance package. The shareholders of the firm would also benefit because the offer for their stock is substantially above the current market price. The CEO learns, however, that plans call for closing a plant that is the major employer in a small town. The firm has always taken its social responsibility seriously, but the CEO is now unsure of how to balance the welfare of the employees who would be thrown out of work and the community where the plant is located against the interests of the shareholders. He is also not sure how much to take his own interests into account.

**Ethical Issue:** Should the CEO support a merger that harms the community but benefits the shareholders and himself?

These four examples give some idea of the ethical issues that arise at all levels of business. The individuals in these cases are faced with questions about ethics in their relations with customers, employees, and members of the larger society. Frequently, the ethically correct course of action is clear, and people in business act accordingly. Exceptions occur, however, when there is uncertainty about ethical obligations in particular situations or when considerations of ethics come into conflict with the practical demands of business. The sales representative might not be sure, for example, about the extent to which he is obligated to provide information about possible delays in delivery. And the director of research, although convinced that discrimination is wrong, might still feel that he has no choice but to remove the woman as head of the team in order to get the job done.

### WRITING PROMPT

#### Judgment Calls on the Job

Describe a situation where you needed to make a decision in which the "right" choice had negative consequences for others or yourself personally. Explain your decision and the reasoning for it.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 1.1.1: Nature of Business

In deciding on an ethical course of action, we can rely to some extent on the rules of right conduct that we employ in everyday life. Deception is wrong, for example, whether we deceive a friend or a customer. And corporations no less than persons have an obligation not to discriminate or cause harm. However, business activity also has some features that limit the applicability of our ordinary ethical views. In business settings, we encounter situations that are significantly different from those of everyday life, and business roles place their own obligations on us. For example, CEOs, by virtue of their position, have responsibilities to several different constituencies, and they face ethical challenges in finding the proper balance among these possibly conflicting responsibilities.

**One distinguishing feature of business is its economic character.** In the world of business, we interact with each other not as family members, friends, or neighbors, but as buyers and sellers, employers and employees, and the like. Trading, for example, is often accompanied by hard bargaining, in which both sides conceal their full hand and perhaps engage in some bluffing. And a skilled salesperson is well versed in the art of arousing a customer's attention (sometimes by a bit of puffery) to clinch the sale. Still,

there is an “ethics of trading” that prohibits the use of false or deceptive claims and tricks such as “bait-and-switch” advertising.

Employment is also recognized as a special relationship, with its own standards of right and wrong. Employers are generally entitled to hire and promote whomever they wish and to lay off or terminate workers without regard for the impact on the people affected. (This right is being increasingly challenged, however, by those who hold that employers ought to fire only for cause and to follow rules of due process in termination decisions.) Employees also have some protections, such as a right not to be discriminated against or to be exposed to workplace hazards. There are many controversies about the employment relationship, such as the rights of employers and employees with regard to privacy and freedom of speech, for example.

The ethics of business, then, is at least in part the ethics of economic or market activity, such as the conduct of buyers and sellers in a market and of employers and employees in the workplace. So we need to ask, what are the ethical rules or standards that ought to govern these kinds of activities? And how do these rules and standards differ from those that apply in other spheres of life?

**A second distinguishing feature of business is that it typically takes place in organizations.** An organization, according to organizational theory, is a hierarchical system of functionally defined positions designed to achieve some goal or a set of goals. Consequently, the members of a business organization, in assuming a particular position, take on new obligations to pursue the goals of a firm. Because business involves economic transactions and relationships that take place in markets and also in organizations, it raises ethical issues for which the ethics of everyday life has not prepared us. Although the familiar ethical rules about honesty, fairness, promise keeping, and the like are applicable to business, it is necessary in many cases to rethink how they apply in business situations. This is not to say that the ethics of business is different from ethics in everyday life, but only that business is a different context, and it presents us with new situations that require us to think through the ethical issues.

### WRITING PROMPT

#### A Business Mindset

What do people usually mean when they defend a business decision by saying, “Business is business”? By what standards should business decisions be evaluated, and how do these compare to the standards in your personal life?

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## 1.1.2: Levels of Decision Making

Decision making in business occurs on three distinct levels:

- the level of the *individual*
- the level of the *organization*
- the level of the *business system*

Situations that confront individuals in the workplace and require them to make a decision about their own response are on the level of individual decision making. An employee with an unreasonably demanding boss, for example, or with a boss who is discovered padding his expense account faces the question: “**What do I do?**” Whether to live with the difficult boss or to blow the whistle on the padding is a question to be answered by the individual and acted on accordingly.

Many ethical problems occur at the level of the organization in the sense that the individual decision maker is acting on behalf of the organization in bringing about some organizational change. Sexual harassment, for example, is an individual matter for the person suffering the abuse, but a manager in an office where sexual harassment is happening must take steps not only to rectify the situation but also to ensure that it does not occur again. The decision in this case may be a disciplinary action, which involves a manager acting within his or her organizational role. The manager may also institute training to prevent sexual harassment and possibly develop a sexual harassment policy, which not only prohibits certain behavior but also creates procedures for handling complaints. Responding to harassment as a manager, as opposed to dealing with harassment as a victim, involves decisions on the organizational level rather than the individual level. The question here is, “**What do we as an organization do?**”

Problems that result from accepted business practices or from features of the economic system cannot be effectively addressed by any single organization, much less a lone individual. Sales practices within an industry, for example, are difficult for one company to change single-handedly because the company is constrained by competition with possibly less-ethical competitors. The most effective solution is likely to be an industry-wide code of ethics, agreed to by all. Similarly, the lower pay for women work results from structural features of the labor market, which no one company or even industry can alter. A single employer cannot adopt a policy of comparable worth, for example, because the problem of lower pay for women is systemic, and consequently any substantial change must be on the level of the system. Systemic problems are best solved by some form of regulation or economic reform. On the systemic level, the relevant question is, “**What do we as a society do?**”

Use Table 1.1 to review these concepts.

**Table 1.1** Levels of Decision Making in Business

Review the type of problem that should be resolved at each level of decision making and the relevant question for each. Then hide the cells in the table to quiz your understanding of these situations.

Level	Type of Problem	Relevant Question
The Individual	The problem confronts an individual and requires that person to make a decision about his or her own response.	What do I do?
The Organization	The problem requires that the individual decision maker act on behalf of the organization to resolve the situation and possibly bring about some organizational change.	What do we as an organization do?
The Business System	The problem results from accepted business practices or from features of the economic system which cannot be effectively addressed by any single individual or organization.	What do we as a society do?

Identification of the appropriate level for a decision is important because an ethical problem may have no solution on the level at which it is approached. The beer marketer described earlier may have little choice but to follow the competition in using tasteless gimmicks because the problem has no real solution on the individual or organizational level. An effective response requires that she place the problem on the systemic level and seek a solution appropriate to that level. Richard T. DeGeorge has described such a move as “ethical displacement,” which consists of addressing a problem on a level other than the one on which the problem appears.<sup>12</sup> The fact that some problems can be solved only by displacing them to a higher level is a source of great distress for individuals in difficult situations because they still must find some less-than-perfect response on a lower level.

### WRITING PROMPT

#### The Authority to Decide

An angry customer is speaking on the phone with a customer service representative. The customer demands a full refund for the defective item she purchased online, although it is past the 30-day period allowed for returns. Describe a possible solution that could be offered at each level of decision making, and explain which level is required to resolve the problem to the customer’s satisfaction.

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## 1.2: Ethics, Economics, and Law

### 1.2 Recognize the role of ethics in the conduct of business, with respect to economic principles and the law

Businesses are economic organizations that operate within a framework of law and regulation. They are organized

primarily to provide goods and services, as well as jobs, and their success depends on operating efficiently and competitively. In a capitalist system, firms operate in an open market by providing goods and services that customers want and by doing so at a low price. This is possible only when the desired goods and services are produced by multiple firms competing to attract customers. Thus, profit is not the end or purpose of business, as is commonly asserted, but is merely the return on the investment in a business that is possible only when the business is competitive. Business has often been described as a game, in which the aim is to make as much profit as possible while staying within the rules of the game, which are set mainly by government through laws and regulations.<sup>13</sup> On the view of business as a game, profit is a measure and the reward of success, but it cannot be gained without also aiming to be competitive. Moreover, it is necessary, in pursuing profits, to observe certain ethical standards, as well as laws and regulation, as a means to the end of profit making.

Both economics and law are critical to business decision making, but the view that they are the only relevant considerations and that ethics does not apply is plainly false. Even hard-fought games like football have a code of sportsmanship in addition to a rule book, and business, too, is governed by more than the legal rules. In addition, a competitive business system, in which everyone pursues his or her self-interest, depends for its existence on ethical behavior and is itself justified on ethical grounds. However, the relationships of business ethics to economics and the law are very complicated and not easily summarized. The following discussion is intended to clarify these relationships.

### 1.2.1: Ethics and Economics

According to economic theory, firms in a free market utilize scarce resources or factors of production (labor, raw materials, and capital) in order to produce an output (goods and services). The demand for this output is determined by the preferences of individual consumers who select from among the available goods and services so as to maximize the satisfaction of their preferences, which is called “utility.” Firms also seek to maximize their preferences or utility by increasing their output up to the point where the amount received from the sale of goods and services equals the amount spent for labor, raw materials, and capital—that is, where marginal revenues equal marginal costs. Under fully competitive conditions, the result is economic efficiency, which means the production of the maximum output for the least amount of input.

Economics thus provides an explanatory account of the choices of economic actors, whether they be individuals or firms. By this account, the sole reason for any choice is to maximize utility. However, ethics considers many

other kinds of reasons, including rights and justice and other noneconomic values. To make a choice on the basis of ethics—that is, to use ethical reasons in making a decision—appears at first glance to be incompatible with economic choice. To make decisions on economic grounds and on ethical grounds is to employ two different kinds of reasoning. This apparent incompatibility dissolves on closer inspection. If the economists' account of economic reasoning is intended to be merely an explanation, then it tells us how we *do* reason in making economic choices but not how we *ought* to reason. Economics as a science need do no more than offer explanations, but economists generally hold that economic reasoning is also justified. That is, economic actors *ought* to make utility-maximizing choices, which is an ethical, and not merely an economic, judgment.

**JUSTIFICATION OF MARKET SYSTEM** The argument for this position, that economic actors ought to make utility-maximizing choices, is the classical defense of the market system. In *The Wealth of Nations*, Adam Smith, the “father” of modern economics, justified the pursuit of self-interest in exchange on the grounds that by making trades for our own advantage, we promote the interests of others. The justification for a free-market capitalist system is, in part, that by pursuing profit, business firms promote the welfare of the whole society. Commentators on Adam Smith have observed that this argument assumes a well-ordered civil society with a high level of honesty and trust and an abundance of other moral virtues. Smith's argument would not apply well to a chaotic society marked by pervasive corruption and mistrust. Furthermore, in his defense of the free market in *The Wealth of Nations*, Smith was speaking about *exchange*, whereas economics also includes *production* and *distribution*.<sup>14</sup> The distribution of goods, for example, is heavily influenced by different initial endowments, access to natural resources, and the vagaries of fortune, among other factors. Whether the vast disparities in wealth in the world are justified is a question of distribution, not exchange, and is not addressed by Smith's argument.

Moreover, certain conditions must be satisfied in order for business activity to benefit the society. These include the observance of minimal moral restraints to prevent theft, fraud, and the like. Markets must be fully competitive, with easy entry and exit, and everyone must possess all relevant information. In addition, all costs of production should be reflected in the prices that firms and consumers pay. For example, unintended consequences of business activity, such as job-related accidents, injuries from defective products, and pollution, are costs of production that are often not covered or internalized by the manufacturer but passed to others as spillover effects or *externalities*. Many business ethics problems

arise when these conditions for the operation of a free market are not satisfied.

**CONDITIONS FOR FREE MARKETS** A common view is that ensuring the conditions for free markets and correcting for their absence are jobs for government. It is government's role, in other words, to create the rules of the game that allow managers to make decisions solely on economic grounds. However, the task of maintaining the marketplace cannot be handled by government alone, and the failure of government to do its job may create an obligation for business to help. Although government does enact and enforce laws against theft and fraud, including such specialized forms as the theft of trade secrets and fraud in securities transactions, there are many gray areas in which self-regulation and restraint should be exercised in order to preserve a well-functioning marketplace.

An example of a gray area in law is the “hardball” tactics employed by Toys “R” Us.<sup>15</sup>

### Case: Toys “R” Us

Toys “R” Us employees allegedly bought inventory off the shelves of a competitor, Child World, during a promotion in which customers received \$25 gift certificates for buying merchandise worth \$100. The employees of Toys “R” Us were accused of selecting products that Child World sold close to cost, such as diapers, baby food, and infant formula. These items could be resold by Toys “R” Us at a profit because the purchase price at Child World was barely above what a wholesaler would charge, and then Toys “R” Us could redeem the certificates for additional free merchandise, which could be resold at an even higher profit. Child World claimed that its competitor bought up to \$1.5 million worth of merchandise in this undercover manner and received as much as \$375,000 worth of gift certificates.

Hardball tactics like those allegedly employed by Toys “R” Us are apparently legal, although Child World stated that the promotion excluded dealers, wholesalers, and retailers. Executives at Toys “R” Us did not deny the accusation and contended that the practice is common in the industry. Child World may have left itself open to such a hardball tactic by slashing prices and offering the certificates in an effort to increase market share against its larger rival. Still, many companies would consider such deliberate sabotage of a competitor to be an unacceptable business practice that is incompatible with the market system—especially when it is their competitors who play hard ball.

**FAIRNESS IN FREE MARKETS** Recent work in economics has revealed the influence of ethics on people's economic behavior. Economists have shown how a reputation for honesty and trustworthiness, for example, attracts customers and potential business partners, thus creating economic opportunities that would not be available otherwise. Similarly, people and firms with an unsavory reputation

are punished in the market. People are also motivated in their market behavior by considerations of fairness. This is illustrated by the “ultimatum bargaining game,” in which two people are given a certain amount of money (say \$10) on the condition that one person proposes how the money is to be divided (e.g., \$5 to each) and the second person accepts or rejects the proposed division. The first person can make only one proposal, and if the proposal is rejected by the second person, the money is taken away and each person receives nothing. Economic theory suggests that the second person would accept any proposal, no matter how small the share, if the alternative is no money at all. Hence, the first person could offer to share as little as \$1 or less. But many people who play the game will refuse a proposal in which they receive a share that is considered too small and hence unfair.<sup>16</sup> They would rather have nothing than be treated unfairly.

Another example of the importance of fairness in business is the action taken by Home Depot in response to a devastating hurricane.

### Case: Home Depot

When weather forecasters predicted that Hurricane Andrew would strike the Miami area with full force, customers rushed to stock up on plywood and other building materials.<sup>17</sup> That weekend the 19 Home Depot stores in southern Florida sold more 4-foot-by-8-foot sheets of exterior plywood than they usually sell in two weeks. On August 24, 1992, the hurricane struck, destroying or damaging more than 75,000 homes, and in the wake of the devastation, individual price gougers were able to sell basics like water and food as well as building materials at wildly inflated prices. But not Home Depot. The chain’s stores initially kept prices on plywood at pre-hurricane levels, and when wholesale prices rose on average 28 percent, the company announced that it would sell plywood, roofing materials, and plastic sheeting at cost and take no profit on the sales. It did limit quantities, however, to prevent price gougers from reselling the goods at higher prices. In addition, Home Depot successfully negotiated with its suppliers of plywood to roll back prices to pre-hurricane levels. Although prices increased early in anticipation of Hurricane Andrew, Home Depot was still able, with the cooperation of suppliers, to sell half-inch plywood sheets for \$10.15 after the hurricane, compared with a price of \$8.65 before, thereby limiting the increase to less than 18 percent.

Home Depot executives explained their decision as an act of good ethics by not profiting from human misery. However, economists explain the behavior of companies like Home Depot and its suppliers by the fact that considerations of fairness force firms to limit profit-seeking behavior. Consumers remember price gouging and other practices that they consider unfair and will punish the wrongdoers by ceasing to do business with them or even by engaging in boycotts. One study found that people do

not believe that scarcity is an acceptable reason for raising prices (despite what economists teach about supply and demand),<sup>18</sup> and so Home Depot and its suppliers, which are there for the long haul, have more to lose than gain by taking advantage of a natural disaster. Evidence also indicates that people in a natural disaster feel that everyone ought to make some sacrifice, so that profit seeking by a few is perceived as shirking a fair share of the burden.<sup>19</sup> Although Home Depot’s actions can be lauded as a display of good ethics, the company also made a shrewd business decision.

Finally, when economics is used in practice to support matters of public policy, it must be guided by noneconomic values. Economic analysis can be applied to the market for cocaine as easily as to the soybean market, but it cannot tell us whether we should allow both markets. That is a decision for public policy makers on the basis of other considerations. A tax system, for example, depends on sound economic analysis, but the U.S. tax code attempts to achieve many aims simultaneously and to be accepted as fair. In drafting a new tax code, a demonstration that a particular system is the most efficient from a purely economic perspective would not necessarily be persuasive to a legislator who may also be concerned about considerations of fairness.

### WRITING PROMPT

#### Toys “R” Us and Home Depot

Consider the actions of Toys “R” Us and Home Depot and contrast their demonstrated views of what is “fair” in business. How might the considerations of fairness in either case contribute to a well-functioning marketplace?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 1.2.2: Ethics and Law

Business activity takes place within an extensive framework of law, and some people hold that law is the only set of rules that applies to business activity. Law, not ethics, these people believe, is the only relevant guide. The reasons that lead people to hold this view are varied, but two predominate.<sup>20</sup>

**TWO SCHOOLS OF THOUGHT** One school of thought is that law and ethics govern two different realms. Law prevails in public life, whereas ethics is a private matter. The law is a clearly defined set of enforceable rules that applies to everyone, whereas ethics is a matter of personal opinion that reflects how we choose to lead our own lives. Consequently, it would be a mistake to apply ethical rules in business, just as it would be a mistake to apply the rules of poker to tennis. A variant of this position is that the law represents

a minimal level of expected conduct that everyone should observe. Ethics, on the other hand, is a higher, optional level. It is “nice” to be ethical, but our conduct has to be legal.

Both versions of this school of thought are mistaken. Although ethics does guide us in our private lives, it is also applicable to matters in the public realm. We can identify business practices as ethical or unethical, as, for example, when we say that discrimination or consumer fraud is wrong. Moral judgments are also made about economic systems. Thus, most people believe that capitalism is morally justified, although it has many critics who raise moral objections.

**The other school of thought is that the law embodies the ethics of business.** There are ethical rules that apply to business, according to this position, and they have been enacted by legislators into laws, which are enforceable by judges in a court. As a form of social control, law has many advantages over ethics. Law provides more precise and detailed rules than ethics, and the courts not only enforce these rules with state power but also are available to interpret them when the wording is unclear. A common set of rules known to all also provides a level playing field. Imagine the chaos if competing teams each decided for themselves what the rules of a game ought to be. For these reasons, some people hold that it is morally sufficient in business merely to observe the law. Their motto is, “If it’s legal, then it’s morally okay.”<sup>21</sup>

In countries with well-developed legal systems, the law is a relatively complete guide for business conduct. In the United States, much of what is unethical is also illegal. However, many other countries of the world have undeveloped legal systems so that ethics, not law, provides the main source of guidance. The relative lack of international law leaves ethics as an important guide for global business. Moreover, no legal system can embrace the whole of morality. Ethics is needed not only to address situations not covered by law but also to guide the creation of new law. The 1964 Civil Rights Act, for example, was passed by Congress in response to the recognition that discrimination, which was legally practiced at the time, is morally wrong.

**WHY LAW IS NOT ENOUGH** Despite their differences, these two schools of thought have the same practical implication: Managers need to consider only the law in making decisions. This implication is not only false but also highly dangerous. Regardless of the view that a practicing manager takes on the relationship of law and ethics, reliance on the law alone is a prescription for disaster, as many individuals and firms have discovered. Approval from a company’s legal department does not always assure a successful legal resolution, and companies have prevailed in court only to suffer adverse consequences in the marketplace. As a practical matter, then, managers need to consider both the ethical and legal aspects of a situation in making a decision for many reasons, including the following.

**First, the law is inappropriate for regulating certain aspects of business activity.** Not everything that is immoral is illegal. Some ethical issues in business concern interpersonal relations at work or relations between competitors, which would be difficult to regulate by law. Taking credit for someone else’s work, making unreasonable demands on subordinates, and unjustly reprimanding an employee are all ethically objectionable practices, but they are best left outside the law. Some hardball tactics against competitors may also be legal but ethically objectionable. Whether the effort of Toys “R” Us to sabotage a promotion by its competitor is acceptable behavior (as discussed in the “Conditions for Free Markets” section) is open to dispute, but not every legal competitive maneuver is ethical. Generally, legislatures and the courts are reluctant to intervene in ordinary business decisions unless significant rights or interests are at stake. They rightly feel that outsiders should not second-guess the business judgment of people closer to a problem and impose broad rules for problems that require a more flexible approach. Companies also prefer to handle many problems without outside interference. Still, just because it is not illegal to do certain things does not mean that they are morally okay.

**Second, the law is often slow to develop in new areas of concern.** Christopher D. Stone points out that the law is primarily reactive, responding to problems that people in the business world can anticipate and deal with long before they come to public attention.<sup>22</sup> The legislative and judicial processes themselves take a long time, and meanwhile much damage can be done. This is true not only for newly emergent problems but also for long-recognized problems where the law has lagged behind public awareness. For example, sexual harassment was not recognized as a legal wrong by the courts until 1977, and it took successive court decisions over two more decades for the legal prohibition on sexual harassment to fully develop. At the present time, legal protections for employees who blow the whistle and those who are unjustly dismissed are just beginning to develop. Employers should not wait until they are forced by law to act on such matters of growing concern.

**Third, the law itself often employs moral concepts that are not precisely defined.** As a result, it is impossible in some instances to understand the law without considering matters of morality. The requirement of *good faith*, for example, is ubiquitous in law. The National Labor Relations Act requires employers and the representatives of employees to bargain “in good faith.” One defense against a charge of price discrimination is that a lower price was offered in a good-faith attempt to meet the price of a competitor. Yet the notion of good faith is not precisely defined in either instance. Abiding by the law, therefore, requires decision makers to have an understanding of this key moral concept. Other imprecisely defined legal concepts are “fair dealing,” “best effort,” and “due care.”

A fourth argument, closely related to the preceding one, is that the law itself is often unsettled, so that whether some course of action is legal must be decided by the courts. And in making a decision, the courts are often guided by moral considerations. Many people have thought that their actions, although perhaps immoral, were still legal, only to discover otherwise. The courts often refuse to interpret the law literally when doing so gives legal sanction to blatant immorality. Judges have some leeway or discretion in making decisions. In exercising this discretion, judges are not necessarily substituting morality for law but rather expressing a morality that is embodied in the law. Where there is doubt about what the law is, morality is a good predictor of how the courts will decide.

Fifth, a pragmatic argument is that the law is a rather inefficient instrument, and an exclusive reliance on law alone invites legislation and litigation where they are not necessary. Many landmark enactments, such as the Civil Rights Act of 1964, the National Environment Policy Act of 1969, the Occupational Safety and Health Act of 1970, and the Consumer Protection Act of 1972, were passed by Congress in response to public outrage over the well-documented failure of American businesses to act responsibly. Although business leaders lament the explosion of product liability suits by consumers injured by defective products, for example, consumers are left with little choice but to use the legal system when manufacturers themselves hide behind “If it’s legal, it’s morally okay.” Adopting this motto, then, is often shortsighted, and businesses may often advance their self-interest more effectively by engaging in greater self-regulation that observes ethical standards.

Use Table 1.2 to review these points and consider their implications for business decisions.

**Table 1.2** Acting Ethically and Legally

Why should managers consider the ethical—and not merely the legal—aspects of a situation when making decisions? Review the arguments in favor of considering both ethics and law in business and the corresponding implication of each argument. Then hide the cells to quiz yourself.

Argument	Implication
1. The law cannot regulate all aspects of business activity.	Not everything that is legal is moral. Not everything that is immoral is illegal.
2. The law is often slow to develop in new areas of concern.	Businesses should not wait to “do the right thing” until forced to act by law.
3. The law often employs moral concepts that are not precisely defined.	To abide by the law, business leaders need to understand key moral concepts well enough to use their own judgment when making decisions.
4. The law itself is unsettled on whether some course of action is legal.	The courts are often guided by moral considerations in making a decision. Where there is doubt about what the law is, morality is a good predictor.
5. An exclusive reliance on law alone and failure to act responsibly can result in legislation and litigation.	Self-regulation and observing ethical standards can prevent unnecessary lawsuits and new laws that may interfere with business.

## 1.3: Ethics and Management

### 1.3 Distinguish between ethical management and the management of ethics, and each of the three main roles of a manager

Most managers think of themselves as ethical persons, but some still question whether ethics is relevant to their role as a manager. It is important for people in business to be ethical, they might say, but being ethical in business is no different than being ethical in private life. The implication is that a manager need only be an ethical person. There is no need, in other words, to have specialized knowledge or skills in ethics.

Nothing could be further from the truth. Although there is no separate ethics of business, situations arise in business that are not easily addressed by ordinary ethical rules. We have already observed that the obligation to tell the truth is difficult to apply to the dilemma faced by the sales rep. In addition, the manager of a sales force might face the task of determining the rules of acceptable sales practices for the whole organization and ensuring that the rules are followed. More broadly, high-level managers have a responsibility for creating and maintaining an ethical corporate climate that protects the organization against unethical and illegal conduct by its members. Furthermore, a well-defined value system serves to guide organizations in uncertain situations and to gain acceptance of painful but necessary change.

#### 1.3.1: Ethical Management and Management of Ethics

A useful distinction can be made between *ethical management* and the *management of ethics*. Business ethics is often conceived as acting ethically as a manager by doing the right thing. This is ethical management. Acting ethically is important for both individual success and organizational effectiveness. Ethical misconduct has ended more than a few promising careers, and some business firms have been severely harmed and even destroyed by the actions of a few individuals. Major scandals in the news attract our attention, but people in business face less momentous ethical dilemmas in the ordinary course of their work. These dilemmas sometimes result from misconduct by others, as when a subordinate is ordered to commit an unethical or illegal act, but they are also inherent in typical business situations.

The management of ethics is acting effectively in situations that have an ethical aspect. These situations occur in both the internal and external environments of a business firm. Internally, organizations bind members together through myriad rules, procedures, policies, and values that must be carefully managed. Some of these, such as a policy



on conflict of interest or the values expressed by a company's mission statement, explicitly involve ethics. Effective organizational functioning also depends on gaining the acceptance of the rules, policies, and other guides, and this acceptance requires a perception of fairness and commitment. For example, an organization that does not "walk the talk" when it professes to value diversity is unlikely to gain the full cooperation of its employees. With respect to the external environment, corporations must successfully manage the demands for ethical conduct from groups concerned with racial justice, human rights, the environment, and other matters.

In order to practice both ethical management and the management of ethics, it is necessary for managers to possess some specialized *knowledge*. Many ethical issues have a factual background that must be understood. In dealing with a whistle-blower or developing a whistle-blowing policy, for example, the managers of a company should be aware of the motivation of whistle-blowers, the measures that other companies have found effective, and, not least, the relevant law. In addition, many ethical issues involve competing theoretical perspectives that need to be understood by a manager. Whether it is ethical to use confidential information about a competitor or personal information about an employee depends on theories about intellectual property rights and the right to privacy that are debated by philosophers and legal theorists. Although a manager need not be equipped to participate in these debates, some familiarity with the theoretical considerations is helpful in dealing with practical situations.

To make sound ethical decisions and to implement them in a corporate environment are *skills* that come with experience and training. Some managers make mistakes because they fail to see the ethical dimensions of a situation. Other managers are unable to give proper weight to competing ethical factors or to see other people's perspectives. Thus, a manager may settle a controversial question to his or her satisfaction, only to discover that others still disagree. Moral imagination is often needed to arrive at creative solutions to problems. Finally, the resolution of a problem usually involves persuading others of the rightness of a position, and so the ability to explain one's reasoning is a valuable skill.

The need for specialized knowledge and skills is especially acute when business is conducted abroad.<sup>23</sup> In global business, there is a lack of consensus on acceptable standards of conduct, and practices that work well at home may fare badly elsewhere. This is especially true in less-developed countries with lower standards and weak institutions. How should a manager proceed, for example, in a country with exploitive labor conditions, lax environmental regulations, and pervasive corruption? Even the most ethical manager must rethink his or her beliefs about how business ought to be conducted in other parts of the world.

### 1.3.2: Ethics and the Manager's Role

Every person in business occupies a role. A role is a structured set of relationships with accompanying rights and obligations. Thus, to be a purchasing agent or a personnel director or an internal auditor is to occupy a role. In occupying a role, a person assumes certain rights that are not held by everyone as well as certain role-specific obligations. Thus, a purchasing agent is empowered to make purchases on behalf of an organization and has a responsibility to make purchasing decisions that are best for the organization. To be a "good" purchasing agent is to do the job of a purchasing agent well.

The obligations of a particular role are sometimes added to those of ordinary morality. That is, a person who occupies a role generally assumes obligations over and above those of everyday life. Sometimes, however, role obligations come into conflict with our other obligations. In selecting people for promotion, a personnel director, for example, is obligated to set aside any considerations of friendship and to be wholly impartial. A person in this position may also be forced to terminate an employee for the good of the organization, without regard for the impact on the employee's life. A personnel director may even be required to implement a decision that he or she believes to be morally wrong, such as terminating an employee for inadequate cause. In such situations, the obligations of a role appear to be in conflict with the obligations of ordinary morality.

Various justifications have been offered for role obligations. One justification is simply that people in certain positions have responsibilities to many different groups and hence must consider a wide range of interests. The decisions of a personnel director have an impact on everyone connected with a business organization, and so denying a promotion to a friend or terminating an employee may be the right thing to do, all things considered. A more sophisticated justification is that roles are created in order to serve society better as a whole. A well-designed system of roles, with accompanying rights and obligations, enables a society to achieve more and thereby benefits everyone. A system of roles thus constitutes a kind of division of labor. As in Adam Smith's pin factory, in which workers who perform specific operations can be more productive than individuals working alone, so, too, a business organization with a multiplicity of roles can be more productive and better serve society.

We cannot understand the role obligations of managers without knowing more about their specific role. Managers serve at all levels of an organization—top, middle, and lower—and fulfill a variety of roles. Usually, these are defined by a job description, such as the role of a purchasing agent or a personnel director. Uncertainty arises mainly

when we ask about the role of top managers, that is, high-level corporate executives who make key decisions about policy and strategy. The higher one goes in a business organization, the more roles one occupies. Many of the ethical dilemmas for top managers are due to conflicts between three main roles.

### 1. Managers as Economic Actors.

One inescapable requirement of the manager's role is to make sound economic or business decisions that enable a firm to succeed in a competitive market. As economic actors, managers are expected to consider primarily economic factors in making decisions, and the main measure of success is profitability. This is the goal of managers who serve as economic actors even if they operate a sole proprietorship, a partnership, or any other kind of business enterprise. However, as previously noted, ethical issues are intertwined with business considerations in decision making, and the soundness of business decisions often depends on the recognition of these ethical issues and their appropriate resolution.

### 2. Managers as Company Leaders.

As leaders of business organizations, managers are entrusted with enormous assets and given a charge to manage these assets prudently. Employees, suppliers, customers, investors, and other so-called stakeholders have a stake in the success of a firm, and managers are expected to meet all of their legitimate expectations and to balance any conflicting interests. Corporations are also human communities in which individuals find not only the means to support themselves but also personal satisfaction and meaning. Top managers, in particular, serve these roles by building and maintaining a company's culture, developing a shared purpose and strategic vision, and, most importantly, meeting challenges and creating a strong, enduring organization.

### 3. Managers as Community Leaders.

Top managers of companies exert enormous power both inside and outside their organizations. Although they are not elected in a democratic process, they nevertheless have many attributes of government officials, such as the power to make decisions that profoundly impact society. The CEO or chairman of a large corporation also serves as an ambassador, representing the company in its relations with its myriad constituencies. In any political system, such great power must be legitimized by showing how it serves some generally accepted societal goals, and managerial power is no exception. So, top managers are expected to demonstrate corporate leadership that serves the interests of society as a whole.

Use Figure 1.1 to review the multiple roles a manager may hold in an organization.

**Figure 1.1** Roles of a Manager

Economic Actors	Company Leaders	Community Leaders
Every manager is expected to base decisions primarily on economic factors so the organization can be competitive and profitable. This requires the ability to solve ethical problems that arise in the course of everyday business.	Top managers are entrusted with managing enormous assets to meet the expectations of multiple parties. They also must <ul style="list-style-type: none"> <li>• build and maintain a company's culture,</li> <li>• develop a shared purpose and strategic vision, and</li> <li>• meet challenges to create a strong, enduring organization.</li> </ul>	Some top managers wield enormous power both inside and outside their organizations. Like elected officials, they are expected to demonstrate corporate leadership that serves the interests of society as a whole.

Many of the ethical dilemmas facing managers involve not merely a conflict between one's personal morality and the morality of a role but also a conflict between the moral demands of different roles. For example, a manager may have to balance fairness to employees or a benefit to the community against an obligation to act in the best interest of the company. Or a CEO may find that he or she cannot easily serve both as a company leader and as a community leader when a decision must be made about a merger that would close a local plant. Some of the hardest dilemmas in business ethics result from such role conflicts.

## WRITING PROMPT

### Ethical Standards for Different Managers

Explain the ethical responsibility of a CEO of a large multinational corporation and that of a proprietor of a small business. What differences, if any, in ethical standards do these leaders face?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 1.4: Ethics in Organizations

### 1.4 Analyze how ethical business conduct is challenged by decision making on individual and organizational levels

The manager who seeks to act ethically and to ensure the ethical conduct of others—to achieve “ethical management” and “the management of ethics,” respectively—must have the ability not only to understand ethical issues and resolve them effectively, but also to appreciate the challenges of ethical decision making and ethical conduct in an organizational setting. The fact that much business

activity takes place in organizations has profound consequences for the manager's role responsibilities for several reasons.

- First, much decision making in business is a collaborative endeavor in which each individual may play only a small role. Many organizational decisions get made without any one person coming to a decision or being responsible for it.
- Second, this collaborative decision-making process is subject to dynamic forces that may not be recognized or understood by any of the participants. As a result, decisions get made that have consequences no one intended or expected.
- Third, many organizational acts are not the result of any one person's actions but are collective actions that result from a multiplicity of individual actions. Many corporate acts are thus "deeds without doers."<sup>24</sup>
- Fourth, organizations themselves create an environment that may lead otherwise ethical people to engage in unethical conduct. Organizational life, according to sociologist Robert Jackall, poses a series of "moral mazes" that people must navigate at their own peril.<sup>25</sup> Consequently, the typical case of wrongdoing in organizations involves missteps that are due more to inadequate thought than to deliberate malice, where people get "lost" in a moral maze.

The following two sections discuss the findings, mainly of psychologists and sociologists, about how ethical mistakes result from flaws in individual decision making and from organizational forces.

### 1.4.1: Individual Decision Making

Wrongdoing is often attributed to the proverbial "bad apple," the individual who knows that an action is wrong but deliberately does it anyway. Such persons can be condemned for having a bad character, and the lesson for others is to develop a good character. This common misunderstanding is misleading both as an analysis of the causes of bad conduct and as a prescription for ensuring good conduct. Of course, there are bad apples, and they should not be hired or, if hired, should be let go once their rottenness is known. This "bad apples" explanation is not very convincing, however, when wrongdoing is committed by people we would identify as good employees or managers. Moreover, when misconduct is widespread in an organization, as is often the case in major scandals, it is not plausible to believe that dozens if not hundreds of people are all "bad apples." Some other explanations are needed, and fortunately psychologists and sociologists have offered many.

**First, many individuals work in environments in which they lack strong guidance and receive conflicting**

**signals.**<sup>26</sup> Often there is strong pressure to follow orders and get the job done. Barbara Toffler, who wrote a book about the last days of Arthur Andersen, relates the tale of an undergraduate who interned at a major accounting firm where he was ordered to make an accounting entry that appeared to be irregular. When he told his superior, "This doesn't look right to me. Why am I doing it?" the reply was, "You're doing it because I told you to do it."<sup>27</sup> Employees who are told "Just do it!" without more explicit instructions and without adequate resources may perceive these words as an implicit order to do whatever it takes to get a job done. Employees are also urged to be "team players" and go along with whatever is being done. Senior managers, in giving orders, often prefer not to give detailed guidance, in part to avoid operational responsibility ("Just do it, and don't tell me how you got it done"). They also sometimes lack an appreciation of the operational difficulties of a job and thus leave to subordinates the task of solving problems their own ways.

**Second, individuals are prone to rationalization and can often effectively persuade themselves that a course of action is morally right or, at least, is not wrong under the circumstances.** Saul Gellerman, in the article "Why 'Good' Managers Make Bad Ethical Choices," identifies four dangerous rationalizations.<sup>28</sup>

- A belief that the activity is within reasonable ethical and legal limits—that is, that it is not "really" illegal or immoral.
- A belief that the activity is in the individual's or the corporation's best interest—that the individual would somehow be expected to undertake the activity.
- A belief that the activity is "safe" because it will never be found out or publicized; the classic crime-and-punishment issue of discovery.
- A belief that because the activity helps the company, the company will condone it and even protect the person who engages in it.

**What are some other rationalizations?**

#### Examples

A particularly common rationalization in business is "everybody's doing it." This retort may even justify some actions when refraining would put a company at a competitive disadvantage (when competitors engage in deceptive advertising, for example) or when business cannot be conducted without so acting (e.g., engaging in foreign bribery).<sup>29</sup> Other rationalizations include:

- "No real harm is done" or "No harm no foul"
- "I deserve this" or "They owe this to me" (sometimes used to justify pilfering)
- "It's for a good cause" (the ends justify the means)
- "If I don't do this, someone else will" (restraint is futile; the consequences will happen anyway)

Sociologists who have studied crime, including the kind of white-collar crime that occurs in business, have described a process of rationalization they call “neutralization” that enables lawbreakers to deny the criminality of their behavior.<sup>30</sup> Among the techniques of neutralization are the following claims:

- one is not really responsible (“I was out of my mind”)
- no real harm was done (“No one will miss that amount of money”)
- the victim deserved the harm (“I was only paying him back”)
- one’s accusers are being unfair (“I’m being singled out for blame”)
- one was following some higher duty or loyalty (“I had to protect my friends”)

All the rationalizations detailed here show the immense capacity of people to engage in self-deception.

**Third, psychologists have identified a number of features of human decision making that produce errors of judgment.**<sup>31</sup> Two of these researchers contend that “unethical business practices may stem not from the traditionally assumed trade-off between ethics and profits or from a callous disregard of other people’s interest or welfare, but from psychological tendencies that foster poor decision making, both from an ethical and a rational perspective.”<sup>32</sup> Some of these “psychological tendencies” are *biases* that shift our decisions in one direction or another, while others are *heuristics* or rule-of-thumb methods that we employ in reasoning.

### What are some examples?

#### Examples

Among the biases and heuristics discovered by psychologists are the following:

- People weigh losses more heavily than gains and thus take greater risks to avoid losing something they have than to gain something that they do not have (loss aversion bias).
- People pay more attention to information that confirms existing attitudes and beliefs instead of focusing on information that poses challenges to their attitudes and beliefs (confirmation bias).
- People tend to persist in a course of action already underway, even in the face of information that should lead them to reconsider their initial decision (commitment or sunk cost bias).
- People are often overconfident about their own prospects for success and about the predictability and the controllability of outcomes, and they make poor judgments about risk, overestimating some risks and discounting others, often ignoring low-probability events and favoring certain over uncertain outcomes.

- In the anchoring and adjustment heuristic, people tend to form an initial choice (“anchor”) early in the decision-making process and then adjust the choice in response to additional information (“adjustment”). Thus, the final decision is heavily influenced by the initial choice, especially given that people often fail to make adequate adjustments.

Psychologists have also noted that biases and heuristics prevent us from foreseeing disasters that we should have seen coming<sup>33</sup> and lead us to overlook the unethical conduct of others.<sup>34</sup> Instances of defective products, accounting fraud, and industrial accidents have been closely studied to reveal the psychological factors that explain how such bad decisions could have been made by decent, diligent, and competent individuals.

These biases and heuristics were developed long ago in the process of evolution to enable human beings to decide and act quickly, especially in dangerous situations with too much information to process fully. Generally, they have served the human race well in pre-historic times but can lead to mistakes in the modern world. Some of the blame for faulty decision making belongs to evolution.

## 1.4.2: Organizational Decision Making

When a company produces a defective product (for example, Merck’s Vioxx or Toyota’s accelerator mechanism) or collapses from massive accounting fraud (as did Enron and WorldCom) or experiences a major industrial accident (such as the Bhopal disaster), the fault generally lies with a series of decisions that can be understood only by examining organizational factors. With the benefit of hindsight, some mistaken decisions can often be found, but sometimes all of the decisions involved seemed reasonable at the time. In such cases, the causes of major scandals and disasters must be sought in the decision-making processes.

Decision making in organizations is marked by four features that contribute to mistakes, big and small.

- First, major decisions are not made all at once with all their consequences and ramifications understood; rather, they are made over time in a series of small steps, no one of which may raise any particular concerns.
- Second, as they are made over time, these multiple decisions develop a commitment to a course of action that is usually difficult to stop.

Once a project is underway, there may be considerable sunk costs that cannot be recovered, and anyone who proposes a halt to a project bears a burden of proof to justify it, whereas little justification is needed to proceed with a project underway. Stopping a project also means that mistakes were made, which it may be difficult for managers to admit since someone must bear the blame. With commitment to a

course of action also comes a psychological tendency to interpret evidence in ways that support one's beliefs and interests. This factor probably goes far toward explaining why, in the development of Vioxx, Merck executives misinterpreted the results of the VIGOR study and concluded that they were due to the heart-protection benefit of naproxen and not to any harmful effect from Vioxx.

The third and fourth factors are the most important: namely,

- the diffusion of information and
- the fragmentation of responsibility that occurs in organizational decision making.<sup>35</sup>

The information that would show that a product has a defect, for example, may exist within an organization in an unassembled form in which different facts are known to different individuals. However, unless this information is assembled and made known to at least one person, there may be no reason for anyone in the organization to conclude that a product is defective. Furthermore, when information is distributed in organizations on a need-to-know basis, each decision maker may have sufficient information for the decisions that that person makes but lack the necessary information for recognizing a defect.

With diffusion of information comes fragmentation of responsibility. Each decision in a series may be made by different individuals or groups, all of whom are discharging their specific responsibility and doing so well, based on

the information available to them. Thus, a researcher testing a drug for its efficacy in treating a certain condition may assume that other researchers have already proven its safety, so safety is not *that* researcher's responsibility. And the salespeople who pitch the drug to doctors assume that the researchers have done their job to test its safety and efficacy; that is not *their* responsibility. In the end, when a drug is recalled, it may be that no one is responsible since no one has failed in discharging his or her responsibility. It is often said that "the buck stops at the top," that the CEO or some other senior executive has a responsibility to ensure, in this example, that a drug is safe, but that person is hostage to a host of decisions made by others that he or she cannot fully assess. In such cases, only the organization as a whole can be blamed or held responsible, and the only remedy to prevent a recurrence is to improve the decision-making process within the organization.

### WRITING PROMPT

#### Organizational Decisions

Describe an instance when a group of which you were a member made a mistake or poor decision. List which factor(s) of organizational decision making contributed to this mistake.



The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## Conclusion: Ethics in the World of Business

Business ethics, as presented in this course, is concerned with identifying and understanding the ethical issues that arise in business and with developing the knowledge and skills needed by a practicing manager to address these issues and to make sound business decisions—that is, decisions that are sound from both an ethical and a business perspective. Ethical issues are an inevitable element of business decision making and are deeply intertwined with managerial practice and economic activity generally. In fact, the success of individual managers, business organizations, and, indeed, the whole economic system depends upon ethical decisions and practices.

Both economics and law are important guides for business decision making, but, as this chapter has shown, they are not complete. Nor can business ethics be understood merely as the treatment of ethical issues from a philosophical perspective. As the work of psychologists and sociologists on organizational misconduct shows, it is not enough merely to determine a right course of action. Misconduct in

organizations is also the result of flaws in individual and organizational decision making that can be corrected only by changes in decision-making processes. Although this course deals mainly with the treatment of ethical issues in business, practicing managers must also address the larger challenge of preventing misconduct within organizations.

### End-of-Chapter Case Studies

This chapter concludes with four case studies.

Unethical decisions can end promising business careers with alarming speed and finality. Each of the following four case studies involves a seemingly "good" person who makes a bad business decision without giving the situation adequate ethical consideration. In "A Sticky Situation," a young sales representative makes a series of seemingly inconsequential half-true statements that lead him, in the end, to seriously mislead an important

client. In the other three cases, top executives (a president and two CEOs) lose their jobs for serious lapses of ethical judgment in covering up the adulteration and misbranding of a product (Beech-Nut Apple Juice), violating government bidding requirements (Bath Iron Works), and falsifying a résumé (Yahoo).

## Case: A Sticky Situation

Kent Graham is still on the telephone, receiving the good news that he has just secured his largest order as an account manager for Dura-Stick Label Products.<sup>36</sup> His joy is tinged with uncertainty, however.

Dura-Stick is a leader in label converting for the durable-products marketplace. Label converting consists of converting log rolls of various substrates (paper, polyester, vinyl) into die-cut, printed labels. The company specializes in high-performance labels for the automotive, lawn and garden, and appliance industries. Dura-Stick has a well-deserved reputation for quality, technical knowledge, and service that enables the company to command a premium price for its products in a very competitive market.

Kent Graham has been with Dura-Stick for two years. Because he came to the company with 10 years of experience in the label industry, he was able to negotiate a very good salary and compensation plan, but his accomplishments since joining Dura-Stick have been mediocre at best. Kent fears that his time with Dura-Stick might be limited unless he starts closing some big accounts. Furthermore, with a wife and two children to support, losing his job would be disastrous. Kent was on a mission to land a big account.

Kent called on Jack Olson at Spray-On Inc., a manufacturer of industrial spraying systems for the automotive painting industry. Dura-Stick has been providing Spray-On with various warning and instructional labels for about 20 years. Jack has been very pleased with Dura-Stick's performance, especially the quality of its manufacturing department under the direction of Tim Davis. After giving Kent another excellent vendor evaluation report, Jack began to describe a new project at Spray-On, a paint sprayer for household consumer use that needs a seven-color label with very precise graphics. This label is different from the industrial two-color labels that Dura-Stick currently supplies to Spray-On.

Jack explained that this was the biggest project that Spray-On has undertaken in recent years and that it would generate a very large order for some label company. Jack then asked Kent, "Does Dura-Stick produce these multi-color, consumer-type labels?" Kent thought for a moment. He knew that a "yes" would give him a better shot at the business, and Dura-Stick might be able to handle the job, even though the company's experience to date was only with two-color labels. Almost without thinking, he replied, "Sure we can handle it, Jack, that's right up our alley!"

"That's great news," Jack shot back. "Now take this sample and give me your proposal by Monday. Oh, and by the way, I hope your proposal looks good, because I would really feel confident if this important project were in the hands of your production people!"

Kent gave the sample to Marty Klein, who is responsible for coordinating the costs and price quotes for new opportunities. Marty took one look at the sample and said emphatically, "We'll have to farm this one out." Kent's heart sank down to his shoes. He knew that Jack would want to work with Dura-Stick only if the labels were produced at Dura-Stick's facility. Yet, he still allowed Marty to put the numbers together for the proposal. Kent presented the proposal to Jack at Spray-On. "Gee, Kent, these prices are pretty high, about 20 percent higher than your competition. That's pretty hard to swallow."

Kent knew that the price would be high because it included the cost of another company producing the labels plus Dura-Stick's usual profit margin, but he countered cheerily, "You know the quality that we provide and how important this project is to your company. Isn't it worth the extra 20 percent for the peace of mind that you will have?"

"Let me think about it," Jack replied.

The next day, Kent got a phone call from Jack.

"Congratulations, Kent, Dura-Stick has been awarded the business. It was a tough sell to my people, but I convinced them that the extra money would be well spent because of the excellent production department that you have. If it wasn't for the fact that Tim Davis will personally oversee production, you guys probably would not have gotten this business."

Kent had to bite his tongue. He knew that Tim would not be involved because the labels would be produced in Kansas City by Labeltec, which would then send the finished labels to Dura-Stick for shipment to Spray-On's facility. Kent also knew that Jack would be completely satisfied with the quality of the labels. Besides, this order was crucial to his job security, not to mention the well-being of his company.

While Jack continued to explain Spray-On's decision, Kent pondered how he should close this conversation.

### SHARED WRITING: A STICKY SITUATION

Decide if Kent's statements were within accepted business practice. Was Kent telling the truth or lying to his client?

Review and comment on at least two classmates' responses, including one that opposes your own.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Beech-Nut's Bogus Apple Juice

When Lars Hoyvald joined Beech-Nut in 1981 as a newly arrived president, the company was in financial trouble.<sup>37</sup> In the competitive baby food industry, the company was a distant second behind Gerber, with 15 percent of the market. After faltering under a succession of owners, Beech-Nut was bought in 1979 by Nestlé, the Swiss food giant, which hoped to restore the luster of the brand name. Although he was new to Beech-Nut, Hoyvald had wide experience in the food industry, and his aim, as stated on his résumé, was “aggressively marketing top quality products.”

In June 1982, Hoyvald was faced with strong evidence that Beech-Nut apple juice for babies was made from concentrate that included no apples. Since 1977, the company had been purchasing low-cost apple concentrate from a Bronx-based supplier, Universal Juice Company. The price alone should have raised questions, and John Lavery, the vice president in charge of operations, brushed aside tests that showed the presence of corn syrup. Two employees who investigated Universal's “blending facility” found merely a warehouse. Their report was also dismissed by Lavery. A turning point occurred when a private investigator working for the Processed Apple Institute discovered that the Universal plant was producing only sugared water. After following a truck to the Beech-Nut facility, the investigator informed Lavery and other executives of his findings and invited Beech-Nut to join a suit against Universal.

Although some executives urged Hoyvald to switch suppliers and recall all apple juice on the market, the president was hesitant. Even if the juice was bogus, there was no evidence that it was harmful. It tasted like apple juice, and it surely provided some nutrition. Besides, he had promised his Nestlé superior that he would return a profit of \$7 million for the year. Switching suppliers would mean paying about \$750,000 more each year for juice and admitting that the company had sold an adulterated product. A recall would cost about \$3.5 million. Asked later why he had not acted more decisively, Hoyvald said, “I could have called up Switzerland and told them I had just closed the company down. Because that is what would have been the result of it.”

Fearful that state and federal investigators might seize stocks of Beech-Nut apple juice, Hoyvald launched an aggressive foreign sales campaign. On September 1, the company unloaded thousands of cases on its distributors in Puerto Rico. Another 23,000 cases were shipped to the Dominican Republic to be sold at half price. By the time that state and federal authorities had forced a recall, the plan was largely complete. In November, Hoyvald reported to his superior at Nestlé, “The recall has now been completed, and due to our many delays, we were only faced

with having to destroy approximately 20,000 cases.” Beech-Nut continued to sell bogus apple juice until March 1983.

### SHARED WRITING: BEECH-NUT'S BOGUS APPLE JUICE

Suppose you were a Beech-Nut customer. Would you feel wronged by the misbranded product? The lack of a recall? The dumping overseas? Explain your response.

Review and comment on at least two classmates' responses, including one that opposes your own.

▶ **A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.**

Post

0 characters | 140 minimum

## Case: Ethical Uncertainty at Bath Iron Works

On May 17, 1991, a quick decision by CEO William E. Haggett almost destroyed Bath Iron Works (BIW), the largest private employer in Maine.<sup>38</sup> Founded in 1884, BIW is a major shipbuilder for the U.S. Navy with 10,400 employees. As one of two companies with the capability to build Aegis naval destroyers worth \$250 million each, BIW was competing fiercely for contracts with its rival, Ingalls Shipbuilding in Mississippi. At 5:30 that morning, a janitor found a 67-page document stamped “Business Sensitive” in a conference room that had been used the previous day for a meeting with navy officials. Two vice presidents who examined the document realized that it contained a detailed comparison of BIW's and Ingalls's costs for building the Aegis destroyer. They delivered the document to Mr. Haggett at 9:00 A.M. The CEO, who was leaving the office to deliver a luncheon speech, examined it for 15 minutes before making a decision. He ordered the two vice presidents to copy the document, return the original to the conference room, and meet with him late in the afternoon to discuss how they should handle the situation.

During the next few hours, the two executives analyzed the information and did some computer modeling based on it. At 2:15 they decided to notify the president of BIW, Duane D. “Buzz” Fitzgerald, who had a reputation for impeccable integrity. Mr. Fitzgerald immediately recognized that the federal Procurement Integrity Act requires defense contractors to certify that they have not been in unauthorized possession of any proprietary information. In addition, BIW is a signatory to the Defense Industry Initiative on Business Ethics and Conduct (DII), which was formed in 1986 in response to revelations by the Packard Commission of irregularities in defense industry contracting. The six principles of the DII require not only that

signatories adopt a written code of ethics, engage in ethics training, and provide mechanisms for internal reporting of possible misconduct, but also that they take responsibility for any violation of law. Principle 4 states, “Each company has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and corrective actions taken.” Mr. Fitzgerald ordered that all copies be shredded and all data erased from the computer. Upon his return, Mr. Haggett agreed with the action taken and admitted that he had made an “inappropriate business-ethics decision.” The CEO personally delivered the original document to Navy officials on-site. However, Mr. Haggett decided not to reveal that copies had been made but to admit only that “no copies existed.”

The Navy launched its own investigation and concluded that the bidding process had not been compromised. An adverse decision could have resulted in suspension or debarment as a government contractor, which would have jeopardized the survival of the firm with devastating consequences for its employees and the surrounding community. As part of the settlement with the Navy, BIW agreed to establish an ethics program headed by an ethics officer, expand ethics training, create a board committee for ensuring compliance, and report to the Navy for three years on the implementation of this agreement.

BIW was still competing for contracts to build at least two new Aegis destroyers, and many at the company feared that lingering suspicion about the use of a competitor’s information would be an impediment. To allay this concern, the two vice presidents who first handled the discovery of the document were asked to leave the company, and William Haggett resigned as CEO. He later severed all connections with BIW, thus ending a 28-year career with a company where his father had worked as a pipe fitter. He lamented that 15 minutes of ethical uncertainty had cost him his job. Buzz Fitzgerald became the new CEO and immediately declared that BIW “must meet the highest ethical standards and avoid even the appearance of impropriety.”

#### SHARED WRITING: ETHICAL UNCERTAINTY AT BATH IRON WORKS

Consider an organization that you work for or have worked for in the past, as a part-time employee, club member, volunteer, or any other capacity. Briefly outline what an ethics program would look like for that organization.

Review and comment on at least two classmates’ responses.

► A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: A Faked Résumé at Yahoo

At the beginning of 2012, Scott Thompson took the reins as the third CEO in five years at the embattled Internet company Yahoo. An early leader in the field, Yahoo was losing its once dominant place to newer rivals, such as Google and Facebook. Repeated failed attempts to turn around the troubled company had produced great turmoil in the executive ranks and discontent among its large workforce. An activist hedge fund, Third Point led by investor Daniel Loeb, had been using its 5.8 percent stake in Yahoo to agitate for greater representation on the board in order to change the company’s direction. With an extensive background in digital technology, including a stint as president at PayPal, an eBay subsidiary, Mr. Thompson brought strong credentials to the top post at Yahoo.

On May 3, Mr. Loeb dropped a bombshell on the Yahoo board of directors. The official biography of Scott Thompson in company documents listed an undergraduate degree from Stonehill College, outside Boston, with majors in accounting and computer science. The only problem with this claim was that the school did not offer a computer science major at the time; Mr. Thompson had apparently obtained only a degree in accounting. Ironically, the hedge fund had discovered the discrepancy through a simple Google search.<sup>39</sup> The challenge for the board, in responding to this revelation, was to decide whether the false claim was an inconsequential innocent mistake that could be easily rectified or an indicator of a more serious matter that might require swift, decisive action.

Mr. Thompson might have put the matter to rest with an immediate full admission and a sincere apology. Instead, he lashed out at Mr. Loeb for using this discovery as a weapon in his fight with the board, and he began to build support among board members and fellow executives. He also blamed the mistake of introducing the false information into his biography on the search firm that had placed him in the presidency of PayPal, a charge the firm indignantly denied in a statement to the board. Furthermore, a radio interview was discovered by the board in which Mr. Thompson not only did not correct an interviewer’s mistaken reference to the computer science major but also added, “That’s really the background I have, and it started back in my college days, and I think that’s really the wonderful part of being an engineer is you think that way.”<sup>40</sup>

In making a decision, the board needed to consider the well-being of the company. An abrupt change in leadership at this time might continue the downward direction of the company’s fortunes and prevent the recovery that Mr. Thompson had been hired to achieve. The clumsy firing of the previous CEO, Carol Bartz, after a contentious two-year tenure, had unsettled the company and prevented a smooth



succession. (She was fired in a telephone call while traveling.) The assault by Third Point reflected the vulnerability of the company to a takeover by disgruntled investors. Employees, too, had become disenchanted with Mr. Thompson's leadership because of the layoff of 2,000 workers (14% of the workforce), which he implemented in an effort to turn around the company. Moreover, the false claim of a computer science degree was perhaps perceived as a more serious matter by workers in Silicon Valley who took great pride in their own technical education. Firing Mr. Thompson might have been popular with investors and employees with their own interests, even if it were harmful to the company.

The top job at Yahoo certainly required a strong technical background, and although his experience at PayPal attested to this expertise, the false claim of a degree in computer science was bound to create uncertainty. Besides technical competence, however, a high leadership position requires confidence in a person's integrity. A statement by Third Point argued that the false claim "undermines his credibility as technology expert and reflects poorly on the character of a CEO who has been tasked with leading Yahoo at this critical juncture."<sup>41</sup> Although a company biography might be considered to be a minor matter, the false information had been conveyed while Mr. Thompson was president of PayPal and was also contained in Yahoo's filings with regulators, which he, as CEO, was legally required to certify for accuracy.

Mr. Thompson was not the first CEO to falsify a résumé. A head of RadioShack who claimed to be a college graduate was discovered in 2006 to have left school after only two semesters; he was fired. Ronald Zarella, the CEO of Bausch & Lomb from 2001 to 2006, claimed to have an MBA that he never earned; he was kept on the job, although the board rescinded a \$1.1 million bonus. An option for the Yahoo board was to terminate Mr. Thompson "for cause,"

which would deny him stock grants worth \$16 million. During the board's deliberations, Mr. Thompson revealed that he had undergone surgery several weeks earlier, which might have impacted his performance, although he did not disclose at that time that it had been for thyroid cancer.

On Sunday, May 13, Mr. Thompson resigned his position, and the board settled the same day with Third Point to allow it three seats on the 12-member board. The new chairman declared, "The board is pleased to announce these changes, and the settlement with Third Point, and is confident that they will serve the best interests of our shareholders and further accelerate the substantial advances the company has made operationally and organizationally."<sup>42</sup>

### SHARED WRITING: A FAKED RÉSUMÉ AT YAHOO

In your opinion, what is the strongest argument for Thompson's resignation? Select one of the alternative endings to Thompson's story below. List the scenario and explain how this controversy might have played out differently.

Review your classmates' responses. Comment on at least two additional alternative endings.

- Thompson's falsification was discovered when Yahoo held a stronger market position and was less vulnerable.
- Thompson held a management position lower than CEO.
- Thompson had assumed responsibility immediately instead of attempting to shift blame.
- Silicon Valley culture esteemed practical education and self-taught skills above technical degrees.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

### Chapter 1 Quiz: Ethics in the World of Business

# Chapter 2

# Ethical Decision Making



## Learning Objectives

- 2.1 Recognize the features of the market system, the ethics of market transactions, and the problems created by imperfect market conditions
- 2.2 Identify the duties and obligations associated with fundamental business roles and relationships in markets and firms
- 2.3 Describe the philosophical and psychological approaches to ethical reasoning and the principles that constitute a moral framework for business conduct

### Case: HP and the Smart Chip

As a leading innovator in the highly competitive computer printer business, Hewlett-Packard (HP) has promoted its “SureSupply” campaign, which tracks and manages users’ toner and ink levels, provides alerts when the cartridge needs to be replaced, and directs users to the HP online store.<sup>1</sup> HP literature boasts, “With a couple of clicks of a button, customers can access cartridge information, pricing and purchasing options that best meet their needs from the reseller of their choice.” The key to SureSupply is a “smart chip,” which is embedded in a cartridge and communicates with the computer to provide information and send messages and alerts. Originally used only with more expensive, high-end printers, HP subsequently extended its smart chip technology across its line of products.

Despite HP’s claim to be providing a “free user-friendly tool,” some customers took a different view of the smart chip. Users of HP ink-jet printers complained that the smart chip was programmed to send a premature low-on-ink (LOI) message, while substantial ink remained in the cartridge. They also contended that the smart chip would render a cartridge inoperable after a predetermined shutdown date that is not disclosed to users. This date was usually the earlier of 30 months after the initial installation or 30 months after the “install-by” date. In some instances, a cartridge could shut down even before it had been installed. Although HP cartridges carry a warranty, the warranty does not apply, among other conditions, for “products receiving a printer generated expiration message.” The smart chip also guides

users to HP’s own web store, where they may order a new cartridge. Once the smart chip had shut down a cartridge, it could not easily be refilled, thus requiring replacement with a new one. (The European Union has prohibited manufacturers from installing smart chips in cartridges in an effort to promote recycling. Indeed, the European Parliament uses only recycled cartridges.)

The HP promotional materials, users’ manuals, and packaging reveal little about the features of the smart chip. The box containing a cartridge generally lists the date of the warranty expiration but not any shutdown date. In an issue unrelated to the smart chip, some users were disconcerted to learn that certain color ink-jet printers used colored ink when printing in black and white in a process known as “underprinting” or “under color addition,” which resulted in more rapid depletion of colored ink. This feature, too, was not commonly disclosed.

When several separate suits were filed between 2005 and 2008 (the courts denied requests for class-action status), HP vigorously defended its practices, denying that it had done anything wrong or improper. The company contended that, overall, the smart chip provided a helpful service to users and ensured a better printing experience. The smart chip was necessary, the company explained, to enable users to monitor ink levels and be prepared when a replacement was needed. In any event, the monetary loss to customers was minor compared with the convenience. The smart chip was also beneficial to HP since replacement cartridges provided approximately half of the revenues of the Imaging and Printing Group, and “consumables” of all kinds generated approximately 10 percent of HP’s total revenue. Typically, printers, like razor holders, are sold at very low cost since the profits lie mainly in the products that go with them. The profit

margin on HP's ink and toner cartridges ranged between 50 and 60 percent.

### How was HP affected by these lawsuits?

#### Expert Analysis

Despite the denials of any wrong or improper conduct, HP agreed in 2010 to settle the suits, which were consolidated into one. In the settlement, HP agreed to state in all on-screen messages, manuals, and other information that the ink-level information is an estimate only, that actual ink levels may vary, and that the

customers need not replace a cartridge until the print quality is no longer acceptable. HP also agreed to explain on its website and in manuals the use of expiration dates and underprinting and also to explain how underprinting may be minimized or eliminated. Finally, HP agreed to set aside \$5 million to provide e-credits to customers who had purchased certain printers and cartridges. These e-credits, which ranged in amounts from \$2 to \$6 depending on the printer in question, could be applied only in the HP online store. The settlement did not address the use of the smart chip, and it continues to be used by HP and many other manufacturers.

## Points to Consider...

Did HP do anything wrong? The company and its customers have different interests that may lead them to different answers. Taking the moral point of view, which is explained in this chapter, requires us to be impartial and to seek out the best reasons. These reasons may not be easy to identify, however, or to apply. As a business, HP may rightly seek to develop its products and market them with a view to profits within certain limits. The smart chip, in the company's view, serves not only to sell more cartridges but also to benefit its customers, which is a win-win situation. Customers may complain not only that they pay more than is necessary for products but that they have been misled or deceived. Yet, how much information is HP obligated to provide? Perhaps we should not consider only a business and its customers since others are affected, as well. A potential business in recycled cartridges is thwarted by the smart chip, and the social problem of waste is exacerbated, as demonstrated by the European Union's prohibition of the chips. Should these matters also be taken into account in our ethical reasoning?

In order to identify what makes acts right and wrong and to determine what we ought to do or what our duties and responsibilities are in particular cases, it is necessary to understand the elements of ethical decision making.

What rules or principles apply to business practice?

This chapter answers this question by dividing business ethics into two parts.

- The first part considers the ethics of the marketplace in which two parties, a buyer and a seller, come together to trade or make an exchange. Although simple in concept, such market transactions are governed by a host of rules or principles that constitute a market ethics. As prominent as market transactions are to business, much business activity also involves roles and relationships, such as the role of an employee and the employer–employee relationship, which are more than mere market transactions.

- The second part of business ethics involves roles and relationships in business, including firms, which are governed by yet other rules and principles. Finally, this chapter offers a framework for ethical decision making that consists of seven basic principles that are widely accepted in business practice.

## 2.1: Market Ethics

### 2.1 Recognize the features of the market system, the ethics of market transactions, and the problems created by imperfect market conditions

The ethics of business is, in large part, the ethics of conduct in a market. In a market, individuals and business firms engage in economic exchanges or transactions in which they relate to each other mainly or entirely as buyers and sellers. Each market participant offers up something in trade in return for something that is valued more, and, in theory, each party leaves the market better off than before, or at least no worse off. Of course, business is more than buyer–seller exchanges, but a useful place to start an examination of ethical decision making in business is with an understanding of the ethics of market transactions.

What duties or obligations do market participants have to each other in making trades or exchanges? Do market actors have any rights that can be violated in market transactions? Are any market transactions unfair or unjust or otherwise morally objectionable? These questions can be addressed in the context of simple market exchanges without introducing the complications that come from considering business as conducted in firms, which is discussed after the ethics of markets transactions.

### 2.1.1: The Market System

In a capitalist economy, major decisions about what goods and services to produce, in what volume to produce them, how to manufacture and market them, and so on are made primarily through a market. Decisions in a market are made

on the basis of prices, which in turn result largely from supply and demand. The principal aim of business firms in a market system is to maximize the return on investment or, in other words, to make a profit. Individuals, as well, are assumed in economic theory to be market actors who trade with each other or else buy products from or sell their labor or other goods to a firm. Like firms, individuals make decisions in a market on the basis of prices and seek to maximize their own welfare to the limits of their assets. Individuals make a “profit” for themselves to the extent that what they gain in trade exceeds what they give up.

**FEATURES OF THE SYSTEM** The market system is characterized by three main features:

1. *private ownership* of resources and the goods and services produced in an economy;
2. *voluntary exchange*, in which individuals and firms are free to enter into mutually advantageous trades; and
3. the *profit motive*, whereby economic actors engage in trading solely to advance their own interests or well-being.

Private ownership in the form of property rights is necessary for a market system because this is what is transferred in market exchanges. In the sale of a house, for example, the seller who owns it transfers the right to that property to the buyer who becomes the new owner. A sale differs from theft or confiscation, moreover, by being voluntary. Whenever a trade takes place voluntarily, we can be sure that both parties believe themselves to be better off (or, at least, no worse off) because, by assumption, no one willingly consents to being made worse off. Finally, it is assumed that each market participant trades solely with a view to his or her own advantage. If two people want the same thing, then a trade might not be possible. But if each person has what the other wants more, then a trade is to the advantage of both. Therefore, trading in a market is an instance of mutually advantageous cooperation.

**JUSTIFICATION OF THE SYSTEM** The main justification of a market system over other forms of economic organization is its promotion of efficiency and hence welfare.<sup>2</sup> The simplest definition of efficiency is obtaining the greatest output for the least input. That is, given any volume of our limited resources—which include raw materials, labor, land, and capital—we want to achieve the greatest volume of goods and services possible. Efficiency is generally considered to be desirable because these goods and services increase our overall welfare, and the more of them that we can get, the greater our level of welfare.

**Example:** If Alice sells a book to Bart for \$10, she apparently values having \$10 more than possessing the book, hence her willingness to sell; and similarly Bart would apparently rather have the book than the \$10 he currently

possesses, hence his willingness to buy. Before the transaction, there was an opportunity to increase the overall level of welfare, and the exchange that takes place turns this opportunity into a reality. Every economic exchange can thus be seen as a welfare-increasing event, and the more trades that take place, the greater the level of welfare.

Similarly, when firms engage in production, they see an opportunity to purchase inputs, such as raw materials, machinery, and labor, which can be combined to yield a product that can be sold to consumers. Like Alice, the sellers of the raw materials, machinery, and labor would rather have the money they receive for selling their various assets, and, like Bart, the consumers would rather have the product than the money they give up in payment. In the end, everyone is better off.

What is true of individual market actors, whether people or firms, is also true of an economy as a whole. In an economy built on markets, laborers, in search of the highest possible wages, put their efforts and skill to the most productive use. Buyers seeking to purchase needed goods and services at the lowest possible price force sellers to compete with one another by making the most efficient use of the available resources and keeping prices at the lowest possible level. The resulting benefit to society as a whole is due not to any concern with the well-being of others, but solely to the pursuit of self-interest. By seeking only personal gain, each individual is, according to a famous passage in Adam Smith’s *The Wealth of Nations*, “led by an invisible hand to promote an end which was no part of his intention.” Smith continued, “Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.”

In addition to welfare enhancement, the market system is morally desirable because it promotes freedom or liberty. The opportunity to make trades is an exercise of liberty by which individuals are able to advance their interests in society, thus promoting democracy. A market is an instance of what Friedrich von Hayek called a *spontaneous order*, which contrasts with the *planned order* of a state-owned, socialist economy, in which a central authority sets goals and organizes people’s activities to achieve them.<sup>3</sup> In a spontaneous order, the only goals are those that individuals set for themselves, and the only coordination is that provided by the rules for people’s interaction, which permit them to enlist the cooperation of others, each in the pursuit of his or her own goals. The advantages of spontaneous order are, first, that it protects and expands the basic rights to liberty and property. Second, a spontaneous order will generate a much greater complexity than could be produced by deliberate design. A planned order is limited by the vision and skill of a few people, but a spontaneous order allows everyone to participate in an economy and make a contribution.

A stronger argument for the market system, and perhaps the decisive reason for the failure of socialism, is the ability of markets to utilize information. A central planner faces the formidable task of gathering all available information about such matters as people's preferences for products, the supply of raw materials, the capacity and condition of machines and workers, the state of distribution facilities, and many other factors. Not only is the amount of information required for economic decision making immense, but also the details are constantly changing. Put simply, the information-gathering and processing requirements of central planning outstrip the capabilities of any one person or group of people. Markets solve this problem by enabling individuals to utilize the information that they possess in ways that can be known by others. This is done mainly through the price system. The prices of all manner of goods and services reflect the available information, and these prices may fluctuate as new information becomes available. Thus, the market system may be justified on the multiple grounds of enhancing welfare, securing rights and liberty, and utilizing all available information.

**MARKET OUTCOMES** Although markets operate, in theory, to make each participant better off and thereby to increase the welfare of all, they also result in distributions of income and wealth that may be criticized on moral grounds. In particular, market transactions function as a means for distributing goods and services, and in so doing, they may produce much greater gains for some parties than for others, so as to increase inequality in society. Thus, a skillful trader, such as Warren Buffett, may parlay a string of successful trades into great wealth, while another trader, through misjudgment or misfortune, may lose everything.

How people fare in markets may depend not only on skill or luck but also their inborn abilities and circumstances of birth, over which they have no control. Market returns are also a function of the amount of risk taken. Thus, an entrepreneur like Bill Gates who bets everything on a single idea stands to reap a fortune or endure failure. Some moral philosophers, such as Robert Nozick, argue that market outcomes are just, no matter how unequal they may be, merely because they result from voluntary transactions. Others, such as John Rawls, hold that market outcomes may need to be altered when they lead to unjust levels of inequality. In any event, the moral justification of markets must address the question of the justness of market outcomes.

### 2.1.2: Ethics in Markets

If a market transaction is wholly voluntary, then how can one market actor wrong another? In a free market, every participant seeks his or her own benefit and has no obligation to protect or promote or otherwise consider the

interest of the other party. Exclusive self-interest is an accepted and justified motive for trading. However, in a market people are able to get what they want only with the cooperation and voluntary consent of others; acquisition without consent is a kind of theft. Consequently, everyone's gains in a market are by mutual agreement or consent, in which case no moral wrongs are possible. Indeed, the philosopher David Gauthier has characterized perfectly competitive markets as morally free zones, where there is no place for moral evaluation.<sup>4</sup> A world where all activity took place in a perfectly competitive market would have no need of morality.

The idea that a market is a morally free zone such that no wrong can occur from each participant pursuing his or her own advantage with the voluntary consent of others presupposes, as Gauthier makes explicit, the ideal of a perfectly competitive, properly functioning market. In such a market, the following points are assumed.

- First, everyone completes an exchange by fulfilling the terms of all agreements. Every market transaction can be viewed as a kind of contract, and the market system requires that participants honor all contracts made. In law, a failure to do this would be called a *breach of contract*, which is a legal and moral wrong.
- Second, a voluntary exchange precludes *force* or *fraud*. Any transfer by force is not a market transaction but an instance of theft or expropriation, which is an obvious legal and moral wrong. By contrast, fraud is a more subtle wrong that is not an uncommon occurrence in market transactions and that, like force, is also prohibited by law. Indeed, fraud, which is discussed in the next section, is a major concern in business ethics.
- Third, market transactions can result in harm to persons that constitute a *wrongful harm* when the harm results from some wrongful act. For example, the harm done to the buyer of a defective product is a *wrongful harm* if the seller has a duty to ensure the safety of the product when properly used. Similarly, an employer has a duty not to discriminate, and so the refusal to hire or promote a person on the basis of race or sex is also an instance of a wrongful harm. Such wrongful harms are the subject of the law of torts, which is often the basis of suits for injury or loss of some kind.
- Fourth, perfect markets require a number of conditions, and when these are not satisfied, the personal and social benefits that result from mutually advantageous cooperation, as described in Adam Smith's invisible hand argument, may not occur. The absence of these conditions leads to a number of commonly recognized situations known as *market failures*, which are discussed later in this chapter.

Consequently, wrongs can occur in actual markets, as opposed to ideal or perfect markets, and market ethics may

be characterized as the ethical rules that apply in imperfect market exchanges or transactions to address recognized market failures. Because market failures are also addressed by much government regulation, there is an extensive overlap between business ethics and the moral rationale or justification for this regulation.

Market ethics—the ethics that applies when the conditions for perfect markets do not exist—can be categorized under these four headings:

1. observing agreements or contracts,
2. avoiding force and fraud,
3. not inflicting wrongful harms, and
4. acting responsibly in cases of market failures.

Since much of business ethics consists of this market ethics, a further examination of the failure to adhere to these four principles follows.

### 2.1.3: Breaches and Fraud

Breach of contract and fraud, which are two wrongs that can occur in market transactions, are not only major concerns of law but also of common morality. Indeed, they are violations of two basic moral values: promise keeping and honesty. Every market trade or exchange is a kind of promise, and so a failure to honor what is agreed to in a transaction is the breaking of a promise. And inasmuch as fraud necessarily involves a knowing or intentional falsehood, it is a form of dishonesty.

Much of business ethics can be reduced to two rules: Keep your promises and be honest!

**BREACH OF CONTRACT** A market actor who fails to perform—by not delivering promised goods or refusing to pay, for example—is obviously breaching an agreement or contract, and such cases of nonperformance are obviously wrong and require little explanation. However, actual contracts are often vague, ambiguous, incomplete, or otherwise problematic, causing reasonable people to be uncertain or disagree about whether a contract's terms have been fulfilled. Disputes of this kind, which are not uncommon, are often taken to court. In actual business practice, three main ethical problems with contracts arise.

1. *They are implicit.* Many contracts in business are not explicitly formulated but are left implicit because of a desire or a need to avoid excessive legalism and to keep some flexibility. Business is sometimes better conducted with a handshake than a written contract. Thus, employee contracts may contain explicit terms about pay and job description, but leave implicit any promises of specific job responsibilities, advancement opportunities, or guarantees of job security. Such matters may be better left to the unstated understandings of implicit contracts rather than to the legally enforceable

language of explicit contracts. However, implicit contracts are subject to disagreements, and since they are generally not legally enforceable, they may be violated with impunity.

**Example:** A laid-off employee may believe that he had been guaranteed greater job security than was the case, or a company may change its policy to offer less job security, which may be legally permissible in the absence of an explicit contract.

2. *They are incomplete.* A perfect contract in which every detail and contingency are addressed may be impossible to formulate because the transaction is too complex and uncertain to plan fully. Even if a fully explicit contract is sought, it may be impossible to draft it in complete detail.

**Example:** In hiring a chief executive officer (CEO), neither the CEO nor the board of a company can anticipate all the situations that might arise and agree upon detailed instructions for acting in each one. Indeed, the CEO is being hired precisely for an ability to manage complexity and to handle unanticipated events successfully. The best that can be done is typically to require the CEO to exert his or her best effort, to set and reward certain goals, and to impose a fiduciary duty to act in the shareholders' interest. The CEO's contract with a firm is necessarily an incomplete contract.

3. *They lack remedies.* The contracts that occur in market exchanges often consider only the duties or obligations of each party to the other and fail to specify the remedies in cases of breach. What ought to be done in cases where one party is unable or unwilling to fulfill a contract? Such situations are often the subject of ethical and legal disputes. While remedies for breaches can usually be made explicit, there is evidence that firms often prefer to leave this matter implicit, in which case courts are called upon to determine a just outcome.<sup>5</sup> One problematic area of justice in breaches occurs when a party does not observe a contract in which the cost of observance would exceed the penalty for breach.

**Example:** A question of ethics arises when homeowners who owe more on a mortgage than a house is worth walk away and return the house to the bank. On the one hand, the homeowner has signed a loan agreement to repay the full amount of the loan, and, on the other, the contract signed provides only for repossession as the penalty for nonpayment.

These three features of contracts—being implicit and incomplete and lacking remedies—give rise to many situations in which the ethical course of action is unclear and disputable. One possible guide in such cases is to try to

determine what more explicit and complete contracts the parties might have agreed to before the situation arose. To use this guide is to ask what the fairest resolution is for both parties.

### WRITING PROMPT

#### Contracts and Trust

Given the discussed advantages and disadvantages of contracts, describe the kinds of situations in which a contract is important and the kinds of situations in which some other means of agreement would be more appropriate.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

**FRAUD AND MANIPULATION** Fraud is one of the most common violations of business ethics, and the many fraud statutes on the books provide a powerful arsenal of legal tools to prosecute people for a wide variety of misdeeds. Consequently, it is essential for business people to understand what actions constitute fraud. A few incautious remarks have led to costly legal judgments and fines and even to years of imprisonment for not a few executives, and some companies have been seriously damaged and even bankrupted by fraudulent schemes.

Fraud is commonly defined as *a material misrepresentation that is made with an intent to deceive and that causes harm to a party who reasonably relies on it*. This definition contains five elements:

1. the making of a false statement or the *misrepresentation* of some fact;
2. *materiality*, which means that the fact in question has some important bearing on the business decision at hand;
3. an *intent to deceive*, which is a state of mind in which the speaker knows that the statement is false and desires that the hearer believe it and act accordingly;
4. *reliance*, by which the hearer believes the statement and relies on it in making a decision; and
5. *harm*, which is to say that the decision made by the hearer on the basis of the misrepresentation leads to some loss for that person.

The first three conditions bear on whether the speaker has acted wrongly, while the last two are relevant to whether the hearer has been wronged and deserves some compensation. The simplicity of this definition is deceptive because each of the five elements hides a host of subtle pitfalls for the unwary. For starters, a misrepresentation need not be spoken or written but may be implied by word or deed, as when, for example, a used car dealer resets an odometer, which is a clear case of consumer fraud.

Partial statements and omissions may constitute fraud when they are misleading within the context provided. Thus, the used car dealer who fails to disclose certain faults or presents them in a way that minimizes their seriousness may be guilty of fraud. Saying nothing, which avoids the risk that a partial statement is misleading, may still constitute fraud if one has a duty to disclose certain information. Such a duty may be the result of one's position or the nature of the facts. Thus, a real estate agent has a duty, as an agent, to inform a buyer of certain facts about a home sale, and the seller generally has a duty to disclose certain hidden faults, such as termite damage.

Generally, opinions, predictions, and negotiating positions do not constitute facts that can be misrepresented. It is not usually considered material, or significant, in negotiation to conceal or even lie about the amount one is willing to accept or pay, which is known as one's "reservation price." Certain amounts of bluffing and exaggeration in negotiation are usually permissible, also on the grounds that the harm is not material. However, one's intentions—such as making a promise that might not be kept—are commonly regarded as facts about a speaker's state of mind, so the misrepresentation of such matters may constitute fraud.

Although intent, being a mental state, is difficult to ascertain, the fact that a person knows the true state of affairs is usually sufficient to establish it. More difficult are cases of willful ignorance where a seller of a house, for example, declines to engage a termite inspector to check suspicious deposits of sawdust in the basement, so he can truthfully tell a buyer, "I don't know," when asked about any termites. Finally, it is often difficult to know whether a party to a transaction actually relied on a misrepresentation in making a decision or did so reasonably. Thus, a seller's deceptive claim to be ignorant of termite damage may have played no role in the buyer's decision. And even if it did, should the buyer have engaged his or her own termite inspector instead of relying (perhaps unreasonably) on the seller's vague denial? Generally, in negotiation, it is unwise to act solely on the other party's words, and market participants have some obligation to determine the facts themselves.

### 2.1.4: Wrongful Harm

Although buyers and sellers in market exchanges have no duty to consider the other party's interest, they still have the obligations of basic morality toward each other and deserve compensation when they suffer some loss when the other party acts in violation of some obligation. For example, a manufacturer has an obligation beyond any warranty extended (which is a kind of contract) to exercise due care and avoid negligence in producing goods, so that a buyer of the product who is injured has some claim for

compensation. In law, this claim is based not on contract law but on tort law, which is the law of wrongful harms. Although wrongful harms can occur in the course of a market transaction—buying the product, in this case—they occur in many instances that do not involve markets at all. Thus, a company might be sued for a defective product not only by the injured buyer but also by anyone who suffers an injury from a defective product. The ethics involved in wrongful harms overlaps with but is much more extensive than merely market ethics.

Market participants give their voluntary consent to a transaction, and in general, consent is an excusing condition when harm is inflicted. That is, the buyer of a stock that declines in value may lose in a transaction, but he or she believed at the time of the purchase that the stock was a good value and was aware of the possibility of loss. Such a person has only himself or herself to blame for the loss. The seller can say, “I am not to blame; it’s your own fault.” On the other hand, the buyer of a defective product consents to the purchase but not to the possibility of injury. Similarly, the victims of a stock fraud, such as the Ponzi scheme perpetrated by Bernard Madoff, cannot be said to have consented to their losses. The ethical transgressions in both cases do not lie in the market transactions themselves but in the wrongs that accompany them, namely, the negligence of the manufacturer and the fraud of Mr. Madoff.

The wrongs in wrongful harms are many and varied and constitute much of business ethics and the whole of tort law. On the side of the violators, these wrongs involve a failure to fulfill a duty, often the duty of *due care*, or involve its opposite, the commission of *negligence*. That is, manufacturers have a duty to exercise due care and not be negligent in the products they market to consumers, in the working conditions they provide for employees, in their environmental impacts they have on communities, and so on. Generally, due care and negligence apply to unintentional harms, but companies also have a duty to avoid intentional harms that result not from negligence but from deliberate or purposeful actions. On the side of victims, wrongful harms typically involve a violation of *rights*. Thus, consumers have a right to safe products; employees have a right to a safe and healthy workplace; and everyone has privacy rights, property rights, a right not to be discriminated against, and so on. The violations of these rights—whether they are due to negligence or intentional actions, or are committed in markets transactions or not—are wrongful harms.

### 2.1.5: Market Failure

The virtues of the market system, including its efficiency and Adam Smith’s “invisible hand” argument, occur only under certain ideal conditions and not necessarily in the real world where people live. Some departures from these ideal conditions are serious enough to be described by economists

as market failures. Indeed, much of business ethics involves questions about how to respond to such failures.<sup>6</sup> Markets fail for four main kinds of reasons, which may be grouped under the headings of imperfect conditions (especially a lack of perfect competition and perfect rationality), externalities, public goods, and collective choice.

**CONDITIONS** The argument that free markets are efficient presupposes certain conditions. The first of these conditions is *perfect competition*. This condition is satisfied when there are many buyers and sellers who are free to enter or leave the market at will and a large supply of relatively homogeneous products that buyers will readily substitute one for another. In addition, each buyer and seller must have full knowledge of the goods and services available, including prices. In a market with these features, no firm is able to charge more than its competitors because customers will purchase the competitors’ products instead. Also, in the long run, the profit in one industry can be no higher than that in any other because newcomers will enter the field and offer products at lower prices until the rate of profit is reduced to a common level.

Competition in actual markets is always imperfect to some degree. One reason is the existence of monopolies and oligopolies, in which one or a few firms dominate a market and exert an undue influence on prices. Competition is also reduced when there are barriers to market entry (as in pharmaceuticals that require costly research), when products are strongly differentiated (think of the iPhone, which many people strongly prefer despite similar alternatives), when some firms have information that others lack (about new manufacturing processes, for example), and when consumers lack important information. Competition is also reduced by *transaction costs*, that is, the expense required for buyers and sellers to find each other and come to an agreement.

The argument that free markets are also efficient makes certain assumptions about human behavior. It assumes, in particular, that the individuals who engage in economic activity are fully rational and act to maximize their own welfare or utility.<sup>7</sup> This construct, commonly called *Homo economicus* or *economic man*, is faulty for at least two reasons. One is that people often lack the ability to gather and process the necessary information to act effectively in their own interests. Economic actors have what is described as *bounded rationality*. The other reason is that human motivation is much more complex than the simple view of economic theory. People often give money to the poor or return a lost wallet, for example, with no expectation of gain. Altruism and moral commitment play a prominent role in our economic life, along with self-interest, and yet economic theory gives them scant regard.<sup>8</sup>

In addition, firms do not always act in the ways predicted by economic theory. To compensate for people’s bounded rationality, business organizations develop rules



and procedures for decision making that substitute for the direct pursuit of profit. For example, it would be impossible to set wages with a view solely to profitability, yet the wage-setting process in companies, which involves many factors, has profit making as an ultimate goal. Firms also do not necessarily seek optimal outcomes, as economists assume, but, in the view of some organizational theorists, they settle for merely adequate solutions to pressing problems through a process known as *satisficing*. The immediate aim of firms, according to these theorists, is to achieve an *internal* efficiency—the well-being of the firm—rather than *external* efficiency in the marketplace.<sup>9</sup>

**EXTERNALITIES** The efficiency argument assumes that there are no spillover effects or *externalities*, which is to say that all costs and benefits associated with the production of goods and services are reflected in the prices that are paid in the market.

**A negative externality is present when prices fail to record a cost of production.** This cost is consequently not borne by either the buyer or the seller but is imposed on third parties, often without their knowledge or consent. These additional costs associated with a particular good or service are said to be externalized by the producer. When the manufacturer of a product is permitted to pollute a stream, for example, there are health and environmental costs that the manufacturer avoids and passes on to other businesses or communities downstream.

Other examples of externalities in present-day markets include:

- inefficient use of natural resources (automobile drivers do not pay the full cost of the gasoline they use and hence overconsume it),
- occupational injuries (which may result when employers underinvest in safety when not they but their employees bear the cost), and
- accidents from defective products (in which consumers, like injured employees, bear the preponderance of the cost).

The presence of negative externalities creates inefficiency in the market because the ability of producers to transfer the costs of production to other parties creates an incentive within the market to overproduce certain harmful goods and services.

**A positive externality exists when prices fail to reflect a benefit for which some party does not have to pay.**

Common examples of positive externalities include:

- goods related to public health, such as vaccines (when individuals who do not receive a vaccine still derive the benefit from others' vaccination);
- creative goods, such as music or film (when individuals can easily download digital copies without paying); and

- goods shared by a community, such as home values (when the value of one person's home appreciates when neighbors make improvements).

The presence of positive externalities also creates inefficiency in the market because certain beneficial goods and services are underproduced when individuals can receive benefits without paying for them and thus have the opportunity of becoming "free riders."

The task of dealing with externalities falls mainly to governments, which have many means at their disposal.<sup>10</sup> In the case of negative externalities, polluters can be forced to internalize the costs of production, by regulations that prohibit certain polluting activities (the use of soft coal, for example) or set standards for pollution emissions. Alternatively, government can create incentives that achieve the same end, such as tax benefits for installing pollution control devices.

Free-market theorists have proposed solutions to the problem of negative externalities that make use of market mechanisms. Under a California law known as the Global Warming Solutions Act, manufacturing companies must have a sufficient number of emission "credits" to match the amount of greenhouse gas pollutants that they emit in their operations. Firms that employ new technologies to reduce greenhouse gas emissions below their allowable credits can trade their surplus credits to firms that emit more than their credits allow.<sup>11</sup> Other proposals allow firms that pollute less than allowed to "sell" their "right to pollute" to other firms. In the case of positive externalities, free-market approaches include the offer of benefits to producers that would otherwise be unobtainable. For example, patent laws assure that inventors of new technologies are paid for their socially beneficial contribution, so that members of society are prevented from becoming "free riders."

**PUBLIC GOODS** Most goods that are traded in markets are private in the sense that they can be owned and consumed by single individuals. Toothpaste, for example, is sold in tubes, and people buy tubes for personal use and commonly do not share them. A *public good*, by contrast, is a commodity that other people cannot be excluded from using. Automobiles are examples of private goods, while roads are a public good in that their use by one person does not exclude their use by others. Once built, roads are accessible by everyone.

A market economy has a well-known bias in favor of private over public consumption. That is, markets produce in abundance goods that can be owned and used by one person. However, goods for the enjoyment of all are generally not available in markets but are provided, usually, by governments. As a result of this bias in favor of private consumption, people spend large sums on their own cars but little to build and maintain a system of roads. Public parks, free education, public health programs, and police

and fire protection are all examples of public goods that are relatively underfunded in an otherwise affluent society.<sup>12</sup>

The reason for this bias is simple: There is little profit in public goods. Because they cannot be packaged and sold like toothpaste, there is no easy way to charge for them. And although some people are willing to pay for the pleasure of a public park, for example, others, who cannot be excluded from enjoying the park as well, will be *free riders*; that is, they will take advantage of the opportunity to use public goods without paying for them. Indeed, if we assume a world of rational economic agents who always act in their own interest, then everyone would be a free rider, given the chance. To act otherwise would be irrational.<sup>13</sup> Consequently, public goods are ignored by the market and are typically left for governments to provide, if they are provided at all.

**COLLECTIVE CHOICE** A further objection to the efficiency argument concerns the problem of *collective choice*.<sup>14</sup> In a market system, choices that must be made for a whole society—a transportation policy, for example—are made by aggregating a large number of individual choices. Instead of leaving a decision about whether to build more roads or more airports to a central planner, we allow individuals to decide for themselves whether to drive a car or to take an airplane to their destination, and through a multitude of such individual decisions, we arrive at a collective choice. The underlying assumption is that if each individual makes rational choices—that is, choices that maximize his or her own welfare—then the collective choice that results will also be rational and maximize the welfare of society as a whole.

The assumption that rational individual choices always result in rational collective choices is brought into question by the *prisoner's dilemma*.<sup>15</sup> Suppose that two guilty suspects have been apprehended by the police and placed in separate cells where they cannot communicate. Unfortunately, the police have only enough evidence to convict them both on a minor charge. If neither one confesses, therefore, they will receive a light prison sentence of one year each. The police offer each prisoner the opportunity of going free if he confesses and the other does not. The evidence provided by the suspect who confesses will then enable the police to convict the other suspect of a charge carrying a sentence of 20 years. If they both confess, however, they will each receive a sentence of five years. A matrix of the four possible outcomes is represented in Figure 2.1.

Obviously, the best possible outcome—one year for each prisoner—is obtained when both do not confess. Neither one can afford to seek this outcome by not confessing, however, because one faces a 20-year sentence if the other does not act in the same way. Confessing, with the prospect of five years in prison or going scot-free, is clearly the preferable alternative. The rational choice for both prisoners, therefore, is to confess. But by doing so, they end up with the second-best outcome and are unable to reach the optimal solution to their problem.

The dilemma in this case would not be solved merely by allowing the prisoners to communicate, because the rational strategy for each prisoner in that case would be to agree not to confess and then turn around and break the agreement by confessing. The prisoner's dilemma is thus like the free-rider problem discussed earlier. If each prisoner has the opportunity to take advantage of the other's cooperation without paying a price, then it is rational to do so.<sup>16</sup> The true lesson of the prisoner's dilemma is that to reach the best possible outcome, each must be assured of the other's cooperation. The prisoner's dilemma is thus an assurance problem.<sup>17</sup> It shows that a rational collective choice can be made under certain circumstances only if each person in a system of cooperative behavior can be convinced that others will act in the same way.

The prisoner's dilemma is not an idle intellectual puzzle. Many real-life situations involve elements of this problem.<sup>18</sup>

**Example:** The factories located around a lake are polluting the water at such a rate that within a few years none of them will be able to use the water, and they will all be forced to shut down or relocate. The optimal solution would be for each factory to install a water-purification system or take other steps to reduce the amount of pollution. It would not be rational for any one factory or even a few to make the investment required, however, because the improvement in the quality of the water would be minimal and their investment wasted. Without assurance that all will bear the expense of limiting the amount of pollution, each factory will continue to pollute the lake and everyone will lose in the end. The most rational decision for each factory individually will thus result in a disastrous collective decision.

### Solving prisoner's dilemma cases

The usual solution to prisoner's dilemma cases—along with those involving externalities and public goods—is government action. By ordering all the factories around the lake to reduce the amount of pollution and backing up that order with force, a government can assure each factory owner that the others will bear their share of the burden. As a result, they could achieve an end that they all desire but could not seek without this assurance. Regulation of this kind is not necessarily incompatible with the operation of a free market.

**Figure 2.1** Prisoner's Dilemma

		Prisoner B	
		Confess	Not Confess
Prisoner A	Confess	A: 5 Years B: 5 Years	A: 0 Years B: 20 Years
	Not Confess	A: 20 Years B: 0 Years	A: 1 Year B: 1 Year

Thomas C. Schelling points out that voluntarism versus coercion is a false dichotomy because coercion also can enable firms to do what they want to do but could not do voluntarily.<sup>19</sup> Firms are not always averse to internalizing costs and providing public goods, Schelling observes, as long as they are not penalized more than their competitors.<sup>20</sup> This condition can also be secured by government regulation.

Another solution for prisoner's dilemma cases is the availability of trustworthy partners and an ability to identify them. If the prisoners in the dilemma situation were trustworthy and their trustworthiness known to each other, then they could confidently not confess and reach the optimal solution. Similarly, the factory owners around the lake could dispense with government regulation if they were all known for their trustworthy character.

### 2.1.6: Summary of Market Ethics

This section shows that much of business ethics is market ethics. This is true not only because much of business is conducted in markets but also because of the importance of imperfect markets and market outcomes for business ethics. In perfect markets there is little if any need for ethics or morality; we would conduct our affairs harmoniously by voluntary, mutually advantageous cooperation. Much of ethics in business is necessary, therefore, to address problems in *imperfect* markets.

These problems include instances of not abiding by agreements (breaches), making false statements (fraud), failures to observe duties and violations of rights (torts), market failures, and market outcomes. In law, the problems of breach of contract, fraud, and torts are addressed by contract law and the law of fraud and torts, respectively, and market failures and market outcomes are appropriate subjects for government regulation and legislation, including antitrust law, consumer law, employment law, securities law, environmental law, taxation, and the like.

Use Table 2.1 below to review some of the ethical problems in imperfect markets and the manner in which they can be addressed.

## 2.2: Roles, Relationships, and Firms

### 2.2 Identify the duties and obligations associated with fundamental business roles and relationships in markets and firms

Insofar as business activity takes place in a market, it involves mainly discrete *transactions*, in which each person pursues his or her own self-interest and is bound only by the ethics of the marketplace. However, business is more than market activity or transactions; it also consists of *roles* that people assume and *relationships* that they build. These roles and relationships evolve out of markets in that people agree *in market transactions* to assume certain roles and enter into certain relationships. Once these roles and relationships are created, though, they give rise to certain moral duties or obligations and to certain rights that are also a part of business ethics. Like the transactions of market ethics, roles and relationships of are voluntarily entered into for mutual advantage, but many of these roles and relationships preclude us from acting solely in our own interest. Indeed, many of them explicitly commit us to acting in the interests of others, thereby forgoing or subordinating our own interests.

The moral importance of roles and relationships is well recognized in the professional ethics of, say, physicians and attorneys. Before assuming these roles, they are bound only by market ethics and the common morality of our society; in particular, they have no duty or obligation to serve other people's interests. Once they assume these roles and build relationships, though, by accepting others as patients or clients, they are pledged to forgo their self-interest and act solely in the interest of these other persons. They enter into these roles and relationships voluntarily, of course, and they are compensated for doing so. However, they now occupy a different moral space: Their actions are now bound by the professional ethics of physicians and attorneys, respectively.

**Table 2.1** Ethics in Markets

Review the ethical problems in imperfect markets that have been discussed in this section, along with their elements and available solutions. Hide the cells in the table to quiz yourself.

Problems	Elements	Solutions
Violation of agreements (breaches of contract)	Breaches of contract often result from agreements that are implicit, incomplete, and lack immediate remedy.	<ul style="list-style-type: none"> <li>• Contract law</li> <li>• Principles for promise keeping</li> </ul>
Misrepresentation of information (fraud)	Fraud involves not only misrepresentation of information but also materiality, intent to deceive, reliance, and harm.	<ul style="list-style-type: none"> <li>• Anti-fraud law</li> <li>• Principles for honesty</li> </ul>
Wrongful harm of others (torts)	Torts are the intentional or negligent violation of rights in such matters as health, safety, privacy, property, and discrimination.	<ul style="list-style-type: none"> <li>• Tort law</li> <li>• Principles for due care</li> </ul>
Market failures (inefficiency)	Market failures result in inefficiency due to low competition, externalities, public goods, and collective choice problems.	<ul style="list-style-type: none"> <li>• Government regulation and legislation like antitrust law, consumer law, employment law, securities law, environmental law, taxation</li> <li>• Special use of market mechanisms</li> <li>• Trustworthy behavior</li> </ul>

Some business people are also professionals—these include accountants, engineers, and others with specialized training—and they, too, are committed to the ethics of their professions. The two most important roles and relationships in business, however, are those of *agent* and *fiduciary*. Like professional roles and relationships, these are entered into voluntarily in market transactions, but by agreeing to become an agent or a fiduciary, a person takes himself or herself out of a market and enters a new moral space in which one is pledged to serve the interests of others and to be bound by the ethics of that role or relationship.

### 2.2.1: Agents and Principals

An *agent* is a party who has been engaged to act on behalf of another, called the *principal*, and the relationship between the two is called an *agency relationship*. Agency relationships are ubiquitous in business and everyday life because of the need to engage other people's skills and knowledge and to allow them to exercise judgment and discretion on our behalf.

To illustrate: In some instances, such as plumbing repairs, we simply hire a worker to perform a specified job, just as a firm engages contractors or suppliers in a market. In other situations, though, it is necessary for a service provider to employ skills and knowledge and to exercise judgment and discretion in acting on our behalf. We cannot ask a physician or an attorney, for example, to perform a particular job at our direction like a plumber; we must ask them to use their skills and knowledge on our behalf without close direction and to act as we would ourselves if only we had their expertise. Another example of an agency relationship occurs in real estate where selling a house requires considerable knowledge and skill, as well as time. Consequently, a seller may engage a real estate agent to act on the seller's behalf, doing what the seller (who is now a principal) would do if that person had the real estate agent's knowledge and skills. An agent thus becomes an extension of the principal, acting in the principal's place, with a duty to use his or her abilities and expertise solely for the principal's benefit.

Business firms have need of many specialized services and thus engage numerous outside service providers as agents. Among such agents are law and accounting firms, banks and investment advisers, insurance agencies, advertising and public relations agencies, management consulting firms, human resource and compensation specialists, safety experts, and the like. The employees of these outside firms have agency duties to their clients. Inside a firm, employees are a major group of agents, especially those employees whose job is not merely to perform a specific task, like assembly line workers, but to exercise judgment and discretion over matters where they know, perhaps better than their employer-principal, how a job is to be

performed. Employees are also agents in matters where they can legally bind their employer or can expose the employer to legal liability. Thus, a purchasing agent who can sign a contract that legally commits a company to a purchase, or a truck driver whose accidents can lead to lawsuits for injuries, is considered an agent of the employer.

The main duties of agents are as follows:

- to work as directed,
- to perform tasks with competence and care, and
- to act in all matters within the sphere of their role in the interest of the principal.

More specifically, an agent has a duty to act only within the scope of his or her authority and not to exceed it, to avoid conflicts of interest that interfere with an ability to act in the principal's interest, and to preserve the confidentiality of information.

#### WRITING PROMPT

##### The Agency Relationship

Given the duties of agents, what corresponding duties (if any) do principals have to their agents? Develop an example of one general duty of principals in a principal–agent relationship.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

### 2.2.2: Fiduciaries and Professionals

In law, all agents are fiduciaries, though not all fiduciaries are agents who are pledged to serve the interest of a principal and empowered to act on that party's behalf. The defining characteristics of a fiduciary are thus different from those of an agent. Although agency relations in business are ubiquitous, nonagent fiduciaries are less common but still very important roles. Being a professional is also a carefully defined role that applies to only a few but important business occupations.

**FIDUCIARIES** A *fiduciary* is a person who has been entrusted with the care of another's property or assets and who has a responsibility to exercise discretionary judgment in this capacity solely in this other person's interest. Common examples of fiduciaries are trustees, guardians, executors, and, in business, officers and directors of corporations, who have a fiduciary duty to the corporation and its shareholders. Partners in a business venture are fiduciaries for each other, and banks and investment firms are fiduciaries for their depositors and clients. Fiduciaries provide a valuable service for individuals who are unable for some reason to manage their own property or assets. A

fiduciary is one part of a *fiduciary relationship*, in which the other party is the *beneficiary* of the fiduciary's service.

A *fiduciary duty* may be defined as the duty of a person in a position of trust to act solely in the interest of the beneficiary, without gaining any material benefit except with the knowledge and consent of this person.

A fiduciary relationship has two elements: *trust* and *confidence*.

Something is entrusted to the care of a person with the confidence that proper care will be taken. Broadly, the duty of a fiduciary is to act in the interest of the beneficiary. This duty, which requires the subordination of self-interest, contrasts with market conduct, in which everyone is assumed to act out of self-interest. As Justice Benjamin Cardozo famously observed, "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is the standard of behavior."<sup>21</sup>

The main elements of fiduciary duty—*candor*, *care*, and *loyalty*—are explained in Figure 2.2.

**PROFESSIONALS** The conduct of physicians, lawyers, engineers, and other professionals is governed by special professional ethics. Which occupations are professions is subject to dispute, but there are three commonly accepted defining features of a profession.

1. **A specialized body of knowledge.** Professionals do not merely have valuable skills, like those of a plumber, but possess a highly developed, technical body of knowledge that requires years of training to acquire.
2. **A high degree of organization and self-regulation.** Professionals have considerable control over their own work, and, largely through professional organizations, they are able to set standards for practice and to discipline members who violate them.
3. **A commitment to public service.** The knowledge possessed by professionals serves some important social need, and professionals are committed to using their knowledge for the benefit of all.

These three features are closely related and mutually reinforcing. It is because professionals possess a specialized body of knowledge that they are given a high degree of control over their work. For the same reason, we leave it to pro-

professionals to determine what persons need to know to enter a profession and whether they know it. There is a danger in giving so much independence and power to professionals, but we have little choice if we are to enjoy the benefit of their valuable specialized knowledge. Consequently, professionals enter into an implicit agreement with society: In return for being granted a high degree of control over their work and the opportunity to organize as a profession, they pledge that they will use their knowledge for the benefit of all. Without this guarantee, society would not long tolerate a group with such independent power.

The standards of a profession include both technical standards of competence and ethical standards. Ethical standards

are generally presented in a code of professional ethics, which is not only a mechanism for the self-regulation of a profession but also a visible sign of the profession's commitment to public service. A code of ethics is not an option for a professional but something that is required by the nature of professionalism itself. Developing a code of ethics is often the first step taken by an occupational group that is seeking recognition as a profession.

**Figure 2.2** Main Elements of Fiduciary Duty

Candor	Care	Loyalty
<p>A fiduciary has a duty of <b>candor</b> to disclose all information that the beneficiary would consider relevant to the relationship. A violation of a fiduciary duty of candor could be</p> <ul style="list-style-type: none"> <li>• an attorney or an investment banker concealing important information from a client, or</li> <li>• the director of a company remaining silent about matters that are critical to a decision under discussion.</li> </ul>	<p>When property or assets are entrusted to a fiduciary—the trustee of a trust, for example—that person should manage what is entrusted with <b>due care</b>, which is the care that a reasonable, prudent person would exercise. It might be a breach of fiduciary duty, for example, for a trustee to invest trust assets in high-risk securities reasonably incompatible with the beneficiary's interests.</p>	<p>A duty of <b>loyalty</b> requires a fiduciary to do two things:</p> <ul style="list-style-type: none"> <li>• Act in the interest of the beneficiary, by acting as the beneficiary would if he or she had the knowledge and skills of the fiduciary.</li> <li>• Avoid taking any personal advantage of the relationship. <i>Taking personal advantage</i> is deriving any benefit from the relationship without the knowledge and consent of the beneficiary.</li> </ul>

### WRITING PROMPT

#### The Duty to Act in Another's Interest

A business hires an interior designer to redecorate its offices and gives the designer an agreed-upon amount to spend on everything that is needed. Would you consider the designer a fiduciary or an agent of the company? What duties would such a person have in this relationship, and what would be the basis for these duties?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

### 2.2.3: Firms

Business is conducted not only in markets but also in firms: business organizations or corporations. Thus, markets and

firms are two basic spheres of business activity to which ethics applies. The focus of this chapter so far has been on markets, although firms have also been considered as market actors. The question arises, therefore, whether firms should be understood merely as market actors for which market ethics is sufficient or whether there is also an ethics for firms and their activities.

What attention must business ethics give to the fact that much business activity takes place in firms, as well as in markets?

**ECONOMIC VIEW** Standard economic theory has traditionally viewed the firm as a market actor like an individual, making decisions with a view to seeking maximum profits. The firm itself has generally been considered to be a “black box,” whose internal workings are irrelevant to economics. The result has been a neglect of any moral issues that arise from the existence of firms as distinct entities. Individuals may act rightly or wrongly, virtuously or not, but the firm itself is merely a market actor who raises no ethical issues beyond those of individuals acting in a market. This view has been replaced in recent decades, however, with an understanding of the firm as a combination of markets and relationships.

The starting point of this new economic view is a 1937 article by the Nobel Prize–winning economist Ronald Coase, “The Nature of the Firm,” in which he asked why all economic activity does not take place in a market.<sup>22</sup> That is, why do firms exist at all? His answer was that some economic activity is more efficiently organized in hierarchical relationships rather than in transactional markets. Thus, according to Coase, there are two fundamental ways of organizing economic production: in markets and in firms, using transactions and relationships, respectively. In a market, all activity is conducted by voluntary, mutually advantageous transactions. In a hierarchical firm, people submit to authority relationships and agree to work in cooperation with or at the direction of others.

Much of the activity of a firm with outside parties—both individuals and other firms—is conducted in arm’s length market transactions, which fall in the domain of market ethics. These other parties include suppliers in commodities markets, consumers in products markets, workers in labor markets, investors in financial markets, and so on. Indeed, much of a firm’s activities consist of market transactions or contracts, and the inside of a firm has many elements of a market system. For example, employees may be aware of their other employment opportunities and may leave if another employer offers higher pay. However, employees also become agents of the employer and assume the duties of an agent while they are employed. Some members of a firm, including the chief officers and board directors, are also fiduciaries with the standard fiduciary duties. To the extent that employees or

other individuals or groups enter into these relationships, they take themselves out of a market and become organized in systems of roles and relationships.

The outcome of the economic view of the firm, then, is that business ethics consists of both the ethics of transactions in a market and the ethics of roles and relationships in a firm. And these two ethics apply to both individuals and firms. Like individuals, firms in markets have the market ethics obligations to observe all agreements or contracts, avoid force and fraud, not inflict wrongful harms, and act responsibly in cases of market failures. Business firms can also be agents and fiduciaries; and in these roles and relationships, they, too, have duties similar to individuals.

**LEGAL VIEW** In the language of the law, a firm is a corporation. This legal entity, the corporation, was described by Chief Justice John Marshall in his famous 1819 *Dartmouth College v. Woodward* decision as “an artificial being, invisible, intangible, and existing only in contemplation of law.” As a legal person which is distinct from the individuals or natural persons who compose it, a corporation can own property, make contracts, sue and be sued, and otherwise conduct business in its own name. The founders of a corporation invest their own private property in a joint venture, but the corporation, once founded, is legally separate from any individuals and is the property of no one. A corporation owns itself in the same way that natural persons belong to no one else. The property that the founders have invested in the corporation is given up in exchange for some set of rights, which include, usually, the right to control the business and a right to receive its profits. A corporation can also survive the death of its founders, and thus it enjoys the convenient benefit of unlimited life or immortality.

The recognition of a corporation as a legal person gives rise to many difficult legal and ethical questions, such as the following:

- Do corporations have the rights that the law confers on natural persons, such as the right to engage in free speech and the right to make political contributions?
- If a corporation is a collective entity that is composed of individuals and yet is distinct from them, how should we view corporate wrongdoing?
- Can a corporation be blamed for misconduct, or should wrongful acts be ascribed only to particular individuals?
- And if corporations can be blamed for wrongdoing apart from the acts of individual members, then can they be held criminally liable and be subjected to criminal penalties?
- If business corporations are founded to enable individuals to conduct business in the corporate form, usually with the aim to make a profit for the founders, should they also be expected to exercise social responsibility?

Debate has long raged over the justification for allowing the creation of corporations as legal persons. One justification, which may be called the *property rights theory*, holds that the right to incorporate is an extension of the property rights and the right of contract that belong to all persons.<sup>23</sup> Just as individuals are entitled to conduct business with their own assets, so, too, have they a right to contract with others for the same purpose. This theory receives support from the fact that the original form of the corporation was the joint stock company, in which a small group of wealthy individuals pooled their money for some undertaking that they could not finance alone.

In a pure expression of the property rights theory, the Michigan State Supreme Court declared in *Dodge v. Ford Motor Co.* (1919),

“A business corporation is organized and carried on primarily for the profit of the stockholders.”<sup>24</sup>

The idea that corporations are the property of the shareholders, to be operated for their benefit, had greater validity before the separation of ownership and control noted by Adolph A. Berle and Gardiner C. Means in their 1932 book *The Modern Corporation and Private Property*.<sup>25</sup> Berle and Means contended that shareholders ceased to be owners in any meaningful sense once effective control of corporations was assumed by professional managers.

Another justification—let us call it the *social institution theory*—holds that the right to incorporate is a privilege granted by the state for some social good and that corporate property thus has an inherent public aspect.<sup>26</sup> The social institution theory emphasizes that a corporation is not merely a private association created for the purpose of personal enrichment but also a public enterprise that is intended to serve some larger social good. Support for this theory is provided by the fact that the earliest joint stock companies were special grants that kings bestowed on favored subjects for specific purposes. In contrast to the *Dodge v. Ford Motor Co.* decision, E. Merrick Dodd argued the following point in a famous 1932 debate with Adolph A. Berle:

The corporation is “an economic institution which has a social service as well as a profit-making function.”<sup>27</sup>

Dodd also argued that corporate managers have a right, even a duty, to consider the interests of all those who deal with the corporation.<sup>28</sup> With the rise of the idea that corporations have a social responsibility, Berle conceded that public opinion and the law had accepted Dodd’s contention that corporate powers ought to be held in trust for the whole of society.<sup>29</sup>

**SOCIOLOGICAL VIEW** Whereas economists speak of firms and legal theorists of corporations, sociologists prefer the term “organization” as the unit of analysis. This term stresses the similarity of business corporations with

other, nonbusiness organizations in which human beings associate for some end.

All organizations are characterized by a common purpose or goal, a structure of roles and relationships, and some decision-making processes.

Viewed as an organization, the firm is a kind of community with all the needs for morality that arise in such organized human groups.

This expanded view of the business firm incorporates most of the economic view and adds other elements.

1. **Organizational Ethical Climates.** Chief among these elements is the existence of distinctive *organizational ethical climates*, which embody certain values, beliefs, assumptions, perceptions, and expectations.<sup>30</sup> The ethical climate of an organization can profoundly influence how members identify moral issues, make moral judgments, arrive at decisions, and ultimately act. Organizations with a good ethical climate can foster exemplary moral conduct, while organizations that lack one can socialize otherwise good people into wrongdoers.<sup>31</sup> A task for the leaders of organizations is to determine the desired ethical climate and to create and sustain it. Members of an organization must understand the organizational ethical climates they encounter, including the climates’ positive and possibly negative impacts.
2. **Organizational Justice.** A second element introduced by the sociological view is *organizational justice*. In organizations, decisions are made that impact individuals and groups in different ways, benefiting some and harming others, and it is critical for smooth organizational functioning that these decisions be accepted as just.<sup>32</sup> People in organizations have a strong sense of fair treatment, of “how things should be,” and they react quickly when they believe they are being treated unfairly. Much of the concern with organizational justice revolves around the rules and policies of organization, both written and unwritten. Managers must ensure, therefore, that an organization’s rules and policies are perceived as just, in both their formulation and implementation.
3. **Organizational Harms.** *Organizational harms* constitute a third element that raises ethical issues on the sociological view. Many of the wrongs that are committed by business are attributable to the whole organization rather than the actions of a few identifiable individuals. They often result from a sequence of decisions that may be made without a full understanding of their consequences. Indeed, it is often difficult to identify any specific individuals who caused a company to produce, say, a defective product or an industrial accident. As one writer observes, “[T]he harm

may seem to be an organizational product that bears no clear stamp of any individual actor.”<sup>33</sup> It is not sufficient, therefore, for individuals in organizations to attend only to their own ethics and strive to be ethical themselves; it is necessary, as well, to appreciate the powerful forces that cause individuals to participate in organizational wrongdoing and to develop procedures and systems for preventing organizational harms.

#### 2.2.4: Summary of Roles, Relationships, and Firms

*Business ethics*, understood as the ethical rules and principles that apply to business conduct, may be divided into two ethics: *the ethics of the market* and *the ethics of roles and relationships*. In the absence of any roles or relationships, including those in firms, individuals and firms relate to each other as market actors who are bound only by the ethics governing market transactions. Although this market ethics is extensive, it does not include a requirement that market actors consider any interests but their own. The justification for this market ethics is due primarily to the fact that the two parties in a market transaction reach a mutually beneficial agreement and give their consent to it. Much of the need for ethics in markets, as well as for regulation, occurs when markets are imperfect because of market failures or when market outcomes are unfair.

Although market actors typically have no obligation to consider the interests of others, such an obligation may nevertheless arise through the market itself when individuals and firms agree to assume certain roles or to enter into certain relationships. Such roles and relationships are ubiquitous in business, and the obligations that attend these roles and relationships, including activity conducted in firms, constitute much of business ethics. The exact content of these role and relationship obligations is determined by the agreements or contracts that create them.

**Example:** Employers and employees are free to contract on various terms, so the obligations that each has toward the other depend, in part, on the specifics of the contracts themselves (although some obligations in the employer–employee relationship, such as to provide a safe and healthy workplace, are due to market ethics). Thus, an employer may have no obligation to offer a pension plan; but when one is offered, the employer (voluntarily) assumes, by contract, the obligations of a fiduciary. The justification for these role and relationship obligations and their specific terms derives, like the justification of market transactions, from the voluntary consent that creates them.

Finally, business firms are constituted by myriad roles and relationships, which involve a complex set of obligations. Many of these obligations are those of market ethics,

while others arise from specific roles and relationships. Because firms are community-like organizations to which people devote much of their life and on which their livelihood depends, managers must attend to the organizational ethical climate, to justice within the organization, and to the possible organizational harms that could be produced.

## 2.3: Ethical Reasoning

### 2.3 Describe the philosophical and psychological approaches to ethical reasoning and the principles that constitute a moral framework for business conduct

Understanding business ethics as the ethics of market transactions and the ethics of roles and relationships provides some useful guidance for decision makers. For starters, anyone in business should begin by asking whether one is dealing with other parties purely as market actors or whether one is in a particular role or relationship. Many of the rules and principles of market ethics and of the ethics of roles and relationships are clearly defined: One should keep all agreements and avoid fraud, for example, and employees should be loyal agents for their employer. In many situations, however, the precise contours of one’s duties or obligations are far from clear and require moral reflection. For example, one may be uncertain whether the failure to disclose certain information constitutes fraud or whether a certain disclosure is a violation of an agent’s duty. The duty of an agent to preserve confidentiality might have an exception for whistle-blowing to protect others, or this duty might be outweighed by a more stringent duty to blow the whistle. Such moral uncertainty requires business people to engage in ethical reasoning to determine what ought to be done or what is the right thing to do.

Ethical reasoning varies in level from the ordinary moral deliberation that everyone engages in before acting to the very sophisticated moral arguments that draw heavily on ethical theory. Complex moral controversies over such ethical issues as privacy, discrimination, worker health and safety, and international labor standards require a deep understanding of the relevant facts in addition to the relevant ethical principles. Examples of ethical reasoning are provided by the extensive studies that governmental and nongovernmental bodies engage in before making recommendations on important matters. Any recommendations made by such bodies are only as strong as the arguments supporting them. Some of the most difficult moral controversies are those in which competing or conflicting ethical considerations are involved.

#### Examples:

- Affirmative action designed to correct past discrimination is alleged by its opponents to be itself a form of discrimination.



- Foreign sweatshops may involve exploitation of workers but are, at the same time, a significant resource for development.
- And finally, ethical reasoning must be reconciled with powerful business imperatives. If the ethical course of action involves significant costs that reduce profits, for example, then the arguments for it need to be very compelling.

Ethical reasoning can be understood both as an intellectual procedure for justifying ethical judgments and as a psychological process whereby people actually form ethical judgments. For an account of the former concept of ethical reasoning, we need to turn to philosophy; for the latter, psychology provides an explanation.

### 2.3.1: Philosophical Accounts

What does it mean for a person to engage in ethical reasoning? One philosophical account is that engaging in ethical reasoning means taking the *moral point of view*. The moral point of view is a standpoint from which ethical decisions are made that structures *how* ethical decisions should be made and *what* considerations are relevant in making a sound ethical decision. In this respect, the moral point of view is an *ideal* perspective that may or may not actually be adopted by all individuals in all circumstances.

**The moral point of view has two important features.**<sup>34</sup> **The first is a willingness to seek out and act on reasons.** The best action, according to one writer, is “the course of action which is supported by the best reasons.”<sup>35</sup> It indicates a commitment to

- use reason in deliberating about what to do and to construct persuasive arguments that consider important facts,
- effectively weigh consequences and alternatives,
- express clear goals or objectives, and
- avoid inferences that are hasty or impulsive.<sup>36</sup>

An important first step in finding the “best reasons” to support a particular ethical decision or course of action, therefore, begins with *principles* that express general values that others can understand as important and worthy of respect. Examples include the requirements to protect individual rights, promote welfare, treat others fairly, and remain honest. These principles are justified not simply because they are preferred or are accepted as part of a prevailing social convention; rather, they are grounded in the most general and comprehensive values recognized by everyone, regardless of specific social circumstances.

A commitment to find the best reasons also involves the consistent application of ethical principles. An individual’s previous decisions set a precedent for future decisions. This is one of the marks of remaining rational in

one’s decisions. For example, if someone maintained that breaking a promise should be avoided because it violates the principle to be honest, then a consistent application of the principle requires the same judgment in other cases involving promises. Ethical principles cannot be selectively applied without regard for how they relate to all similar situations.

Astute observers will quickly reply that different cases always exhibit subtle variations and that what a principle entails in one situation may vary from its implications in others. Suppose, for example, that a promise that was obtained through coercive means is actually harmful to the person who made the promise. Does the principle to remain honest require that this person honor a promise made under these circumstances? In such a case, unique facts may justify a decision to break the promise even if breaking promises should *generally* be avoided because of the high value we place on honesty. The presence of coercion provides a special reason that weighs against keeping a promise for reasons of honesty. The important point, however, is that this decision-making process still remains focused on finding the best possible reasons for justifying departures from the otherwise consistent application of a principle. Finding the best reasons to justify an ethical decision involves a careful consideration of the particular facts of a case, in light of the general ethical values expressed in principles. Sound ethical decisions recognize the general importance of principles, while also acknowledging that there are novel situations in which particular facts justify modifying what a principle ordinarily requires.<sup>37</sup>

**A second important feature of the moral point of view is that it requires us to be impartial.** We must regard the interests of everyone, including ourselves, as equally worthy of consideration. This does not entail that everyone’s interests always deserve equal weight but only that everyone’s interests deserve *consideration* in making sound ethical decisions. This feature of the moral point of view allows one’s own self-interest to be part of an overall assessment about what course of action should be taken, but it precludes the point of view that one’s self-interest is the only relevant consideration in making a sound ethical decision.

Notice that this feature of impartiality is captured in the content of the ethical principles previously discussed. The principles to respect individual rights, enhance welfare, treat others fairly, and be honest are examples of how sound ethical decisions advance others’ interests, for their own sake. These principles also underscore how the moral point of view is, by its very nature, a public point of view in the sense that it involves a shared set of principles that can be accepted and observed by everyone.<sup>38</sup> A good test of the moral point of view is whether our colleagues, friends, and family understand and accept the decisions we make. A decision made from the moral point of view can

withstand and even invites this kind of openness and scrutiny because it is expected that ethical decisions impartially balance the interests of everyone.

### WRITING PROMPT

#### The Moral Point of View

How is adopting a “moral point of view” different from what is commonly considered “being reasonable”? What are some challenges to ethical reasoning?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 2.3.2: Psychological Accounts

Psychologists, who are concerned to describe how we actually reason in matters of ethics as opposed to what constitutes sound ethical reasoning, generally consider this subject as part of a larger process of *decision making* that results in *behavior*. What psychologists have concluded from experimental observations is that our decisions and consequent behavior are based far less on reasoning than is

commonly thought. Many of our judgments about right conduct are attributed by psychologist Daniel Kahneman to quick and largely subconscious intuitive reactions, which he calls System 1 thinking.<sup>39</sup> The kind of ethical reasoning that consists of the conscious consideration of good reasons and the logical evaluation of arguments—which philosophers idealize—occurs only infrequently and with great difficulty in System 2 thinking, which is utilized typically only when intuitions fail. Decisions made in System 2 seldom run counter to intuitive reactions and, indeed, often may serve merely to rationalize them.

Another perspective on the psychology of ethical decision making and ethical behavior is that of Lawrence Kohlberg, who proposed the theory that people develop the cognitive ability to engage in ethical reasoning through a series of three levels, each divided into two stages, in a process that takes place from infancy to adulthood (see Figure 2.3).<sup>40</sup>

A disturbing discovery of psychologists is that higher levels of ethical reasoning—Kahneman’s System 2 or Kohlberg’s Level 3—do not necessarily produce more ethical behavior. These higher levels may involve greater intellectual engagement (Kahneman) or cognitive development (Kohlberg), and they may also enable individuals

**Figure 2.3** Kohlberg’s Six Stages of Moral Development

Level 3 Post-Conventional Morality	<b>Stage 6: Universal Principle Orientation</b>
	Motivation: To live in a just society of free and equal persons.
	Perspective: Respects all people as free and equal, and recognizes abstract, general moral principles (such as rights and justice) as binding on all people.
	<b>Stage 5: Social Contract and Individual Rights Orientation</b>
	Motivation: To satisfy self-interest by cooperating with others.
	Perspective: Recognizes that people have different interests that can be reconciled by mutually advantageous cooperation.
Level 2 Conventional Morality	<b>Stage 4: Authority and Social Order Orientation</b>
	Motivation: Conformity to requirements of living in society.
	Perspective: Recognizes importance of system for social order.
	<b>Stage 3: Good Interpersonal Relations</b>
	Motivation: Conformity to the expectations of others.
	Perspective: Respects the interests of others.
Level 1 Pre-Conventional Morality	<b>Stage 2: Self-Interest Orientation</b>
	Motivation: What’s in it for me?
	Perspective: Sees that others have interests that can be manipulated for own benefit.
	<b>Stage 1: Obedience and Punishment Orientation</b>
	Motivation: What’s going to happen to me?
	Perspective: Recognizes only self and own interests.

**Table 2.2** Moral Development According to Kohlberg

Try to identify the stages associated with each level of moral development, as well as how these levels correspond to an increasing capacity for ethical reasoning. Hide the cells in the table to check your understanding.

Level	Stages	Ethical Reasoning
1. Pre-Conventional Morality	1. Obedience and Punishment Orientation 2. Self-Interest Orientation	People are focused on themselves and incapable of other-oriented ethical reasoning or behavior.
2. Conventional Morality	3. Good Interpersonal Relations 4. Authority and Social Order Orientation	People* are mindful of others, understand rules and laws, and conform to societal expectations. *Most adults
3. Post-Conventional Morality	5. Social Contract and Individual Rights Orientation 6. Universal Principle Orientation	People* can engage in mutually advantageous cooperation, understand the value of abstract moral principles, and practice sophisticated ethical reasoning. *Fewer than 20% of adults

to make sounder judgments about right conduct; but they may not actually lead individuals to act more ethically—or to be as ethical as they think they are.<sup>41</sup> Research has shown that people’s predictions about how ethical they would be in hypothetical situations often conflict with their actual behavior.<sup>42</sup> The same disconnect applies to the philosopher’s other central concept of character or virtue: A strong moral character may prove to be a weak bulwark against involvement in unethical conduct.<sup>43</sup> Both the decisions we make and the behavior that follows are subject to many psychological quirks that are embedded deeply in the human brain. Moreover, character turns out to be a highly malleable and fluctuating factor in our decision making and behavior.

One factor identified by psychologists as a counter to the roles of reasoning and character in decision making and behavior is *context*. Context matters, they say. In particular, human beings have strong tendencies to submit to authority and to conform to those around them. Thus, the presence of an authority figure or an outspoken peer may influence people unawares. Such environmental factors as whether others are watching or time is short have been shown to affect people’s degrees of honesty, generosity, and the like. Individuals with a fixed character may thus act differently under different environmental conditions. A possible explanation for people’s faulty predictions about how ethical they would be is that decisions about hypothetical future situations focus attention on general principles of right conduct, while decisions made at the time of an action are influenced more by practical considerations. For example, a test subject who is certain that she would give to a worthy cause at some future date may fail to do so when the time arrives if she is concerned about having enough money for lunch.<sup>44</sup>

A second important factor cited by psychologists that counters reasoning and character is *rationalization*, which is to say people’s ability to find justifications for what they want to do. This ability to rationalize conduct in ourselves that we might quickly fault in others is facilitated by many means, including partial and distorted perceptions and

fabricated and conveniently suppressed memories. Research has found that people cheat more than they care to admit, but that they also want to maintain a positive image of themselves as basically ethical.<sup>45</sup> The psychologist Dan Ariely explains this discrepancy: “Essentially, we cheat up to the level that allows us to retain our self-image as reasonably honest individuals.”<sup>46</sup> In sum, ethical reasoning as described by psychologists is far less a matter of an ethereal mind, as in the philosophers’ idealized view, and more rooted in the corporeal brain of social animals.<sup>47</sup>

Use Table 2.2 to review Lawrence Kohlberg’s stages of moral development and their significance.

### 2.3.3: Framework for Reasoning

No framework can be comprehensive enough to capture the full complexity and diversity of ethical reasoning. However, it is possible to formulate a few basic ethical principles that are commonly recognized by business people and are expressed in corporate codes of conduct.

**AWARENESS OF ISSUES** Of course, a framework is of no use unless a person recognizes that a situation presents an ethical issue that requires some moral reflection. So an awareness of the ethical dimensions of a situation is a necessary precondition for the application of any framework. One factor that might make one aware of an ethical issue is a consideration of any *harm* that is done. What makes moral wrongdoing of any significance is that someone is usually made worse off. Not every action that harms another is wrong, but any harm should be investigated for possible wrongdoing. That is, anytime a person is harmed, we should stop to consider whether a moral wrong has occurred. Hence, a careful consideration of the consequences of any action helps increase moral awareness.

For example, illegal copying of software might seem like a victimless crime, but a thorough search for consequences would reveal the harm done to software developers and legitimate users. The whole of society would be worse off without respect for intellectual property rights. Another factor that increases moral awareness is the

language used to describe actions. Thus, to speak of *stealing* software or of software *piracy* makes us aware of the moral issues at stake.

## WRITING PROMPT

### Personal Awareness of Issues

List several ethical issues in business that you are personally concerned about or that you think create serious problems in society. Why do you characterize these issues as *ethical* issues? What ethical values or principles underlie each?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

**IDENTIFYING ISSUES** Once we are aware that there may be a moral issue in a situation, the next task is to identify that issue. This task is facilitated by gathering and understanding all the relevant facts, including the full range of consequences. Following this step, the major task of ethical reasoning is to identify the relevant ethical principles and subsequently to determine how to honor best the values expressed in them. These principles may be grouped under seven headings as part of a framework for ethical reasoning (see Figure 2.4 below).

**Figure 2.4** Framework for Ethical Reasoning



1. **Welfare.** We often use the overall impact on people's welfare—"The greatest good for the greatest number"—as a justification for making social improvements, and we consider the alleviation of suffering (after a natural disaster, for example) to be a moral imperative. Although the promotion of welfare is a good, a person may have no duty or obligation to promote it in any given instance, and some harm may result without anyone being responsible for it. In

general, inflicting harm becomes a moral matter only when some wrong is committed, which was described previously as a *wrongful harm*. Still, welfare is an important value in ethical reasoning: Welfare should be promoted, and any infliction of harm requires some moral justification.

In business, the welfare principle requires that a manager take into account the impacts that personnel decisions and policies have on employees, that products and services have on consumers, and that corporate activities have on communities. Although layoffs, for example, are sometimes unavoidable, they should be done in ways that minimize the human cost and enable employees to seek other employment. Manufacturers have an obligation to ensure that their products are reasonably free of defects that can cause serious injury or death. When companies engage in activities that harm communities—as when banks were charged with refusing loans in poor areas, a now-illegal practice known as "redlining"—they commit a moral wrong.

2. **Duty.** A duty or an obligation (the two concepts are used here interchangeably) is a moral requirement to act in a certain way, something that we *ought* to do. Such a requirement may be one imposed on all persons, such as a duty to tell the truth or to keep promises. Many duties in business arise from agreements or contracts, which are kinds of promises, and from the assumption of specific roles and relationships, as is done by agents and fiduciaries (who have an agency and a fiduciary duty, respectively). Duties are especially associated with professionalism since professionals explicitly assume certain responsibilities that they have a duty to fulfill. A person who has a duty is expected to fulfill it without regard for his or her own interest, which means that a person with a duty, say a fiduciary, is expected to be diligent, to exercise care and loyalty, to not engage in self-dealing, and to avoid conflicts of interest that would interfere with the performance of a duty.

3. **Rights.** A right is an entitlement whereby a person is due certain treatment from others. Rights are often said to be correlated with duties such that if one person has a right, then another person has a duty to treat others in a certain way. In business, certain rights are generally recognized for employees, including the right to privacy, a right not to be discriminated against, and a right to a safe and healthy workplace. Other rights are commonly accorded to consumers (consumer rights) and investors (the rights of bondholders and shareholders). One of the most important rights in business is property rights, which are basic to markets (since a transaction is a transfer of property rights) and

important for profitability (without patent rights, for example, innovation would be discouraged). Rights are also closely related to the welfare principle inasmuch as many wrongful harms are wrong precisely because they involve the violation of some right. For example, a person may be harmed when refused a job, but a refusal to hire itself may not be a wrongful harm unless it involves a violation of a right, such as the right not to be discriminated against.

4. **Fairness.** Fairness or justice—which means, very roughly, equal treatment or different treatment according to some justified differences—is applied to a wide range of activities and practices in business. We speak of fairness in market exchanges (with regard to committing fraud, for example, taking unfair advantage of another or setting a fair price), of fair competition (which rules out monopolies, anticompetitive sales practices, and price-fixing), of fair labor practices (treating employees fairly in hiring and promotion, offering fair wages, allowing collective bargaining), of the fair sharing of burdens (not being a freeloader or a free-rider), and of fairness to creditors and investors (treating them fairly in bankruptcy, for example, or in matters of corporate governance). Fairness or justice is also closely related to rights inasmuch as unfair or unjust treatment often involves violating someone's rights. Thus, discrimination is unfair, but it is also a violation of rights. In this case, applications of the concepts of fairness and rights may be merely different ways of describing the same moral wrong.
5. **Honesty.** Although honesty may be regarded as a duty—a duty to tell the truth—it is important enough in business to be considered a basic ethical principle. As previously noted, markets require a certain amount of information, and fraud, which involves the misrepresentation of a material fact, is a prominent violation of market ethics. Furthermore, the business system requires an abundance of accurate and reliable information. This is especially true of financial information, which companies are required to disclose and which is subject to certified audits. Accounting fraud is a particularly serious breach of honesty that causes a great deal of harm. Honesty is a value that is lost when bribes are paid to public officials since such corrupting payments deprive countries of the honest services of their officials. Honesty is also an important element in developing the kind of trust, with employees, customers, and the public, that success in business requires. It is integral to a company's reputation.
6. **Dignity.** The concept of dignity expresses the fundamental ethical principle that all people deserve respect as human beings. All moral systems regard persons as

autonomous moral agents who should be free to make their own decisions and pursue their aims in life. This view is expressed in Immanuel Kant's idea that everyone should be treated as ends in themselves and not as a means to be used solely for the benefit of others. Human dignity is denied when people are subject to violence, coercion, manipulation, degradation, or the risk of serious injury or death. Often, people's dignity is denied when their rights—especially fundamental human rights—are violated. The principle of dignity is most commonly employed in business in operations in less-developed countries where standards of acceptable business conduct may be lower or ineffectively enforced. In particular, environmental damage from mining and oil production and working conditions in garment factories have been criticized as violating a principle of dignity or respect for persons.

7. **Integrity.** Integrity is an elastic term that denotes a person of character or virtue who holds the right values and has the courage of his or her convictions.<sup>48</sup> According to Robert Solomon, "Integrity is not so much a virtue itself as it is a complex of virtues, the virtues working together to form a coherent character, an identifiable and trustworthy personality."<sup>49</sup> The concept is also widely adopted in business codes of conduct not only to describe an ideal for employees but also to characterize the company itself. Motorola, for example, has adopted the slogan "Uncompromising Integrity" as its guide for conduct worldwide. Lynn Paine also uses the term "integrity strategy" to describe a value-based form of internal control, which she calls "moral self-governance."<sup>50</sup> A person or an organization with integrity would be one that adheres to the other six ethical principles described here.

**RESOLVING ISSUES** These seven principles of accepted business conduct express virtually the whole of business ethics. Their usefulness as a guide, though, is limited by the problem of interpretation or application. How one uses this framework in practice to resolve issues is critical. The main value of these principles lies in posing a set of questions that a person should ask when making a decision in a situation that raises ethical issues:

- Who is affected by any proposed course of action? Is anyone harmed, and if so, can the harm be justified?
- What is my duty in this situation? In particular, are there any special duties that belong to any role or relationship that I am in?
- Are anyone's rights being violated, and if so, can the violation be justified?
- Is any proposed course of action fair to all affected parties?

- Am I being entirely honest in my decision?
- Am I showing respect for all persons involved?
- Finally, is the decision one that would be made by a person of integrity?

In addition to these questions, there are others that can guide one in making the right decision by testing whether one has applied the seven principles correctly. Having applied these principles, a decision maker should also develop a sound rationale that supports the correctness of the application. Since the results of ethical reasoning must be defensible to others and not merely acceptable to oneself, a person might consider how the decision would appear to other parties, especially any ones adversely affected. How decisions appear to others be tested in a number of ways, as shown in the box at right.

#### Tests of Ethical Decisions

- **The “sunshine test”**  
How confident one feels that any decision could be defended in a public forum
- **The “newspaper test”**  
How willing one would be for a full account of one’s actions to appear in a newspaper
- **The “mirror test”**  
How one feels looking in a mirror
- **The “legacy test”**  
How one would like to be remembered
- **The “tombstone test”**  
What one would want engraved on a tombstone

## Conclusion: Ethical Decision Making

Ethical decision making in business is often difficult and complex. Some situations are easily handled because what one ought to do or what is right and wrong is evident. Those situations that give us pause or produce moral anguish require careful thought and ultimately an ability to engage in ethical reasoning. This chapter contributes to an understanding of ethical decision making by offering a division of business ethics into two parts: an ethics of the market and an ethics of roles and relationships, including firms. In business, we deal with some parties purely as market actors who are on the other side of a market transaction or exchange. For such market activity, certain moral rules or standards apply. Much of business, however, involves roles and relationships and takes place in firms or organizations. These roles, relationships, and firms arise in a market, but, by mutual agreement in a market, we take ourselves out of the market and govern our actions by a different “ethics,” the ethics of these roles and relationships.

When we attempt to think through the ethical issues that arise in business, we are engaging in ethical reasoning, which may be conducted on different levels. Ethical theories, which are presented in the next chapter, can guide ethical reasoning on the highest level by providing the most comprehensive and fundamental grounds for our moral beliefs and judgments. Fortunately, substantial moral arguments can be constructed that do not require an understanding of these theories. Most of our everyday ethical reasoning employs familiar ethical concepts and principles that can be readily understood and applied. Accordingly, this chapter provides a framework of seven basic ethical principles that are sufficient for most business decision making.

## End-of-Chapter Case Studies

This chapter concludes with three case studies.

Each case provides opportunities to explore different aspects of two important themes presented in this chapter: the ethics of the market and the ethics of roles and relationships. At the Harvard endowment fund, managers were paid for performance, which was spectacular, but the reaction from alumni, faculty, and students brought into question the fairness or justice of the market as a mechanism for determining appropriate compensation. The Bankers Trust case illustrates a common quandary for service providers: Are they merely market actors, bound only by the ethics of the market, or are they in a relationship that requires them to consider the best interests of a client? The decision of a few partners at the tax and consulting firm KPMG, despite reservations by others, to pursue a legally questionable line of business reflects a dismissive attitude toward legal compliance.

### Case: Lavish Pay at Harvard

In 2004, Jack R. Meyer, the head of Harvard University’s \$20-billion endowment fund, was under pressure to change the compensation plan for the fund’s top investment managers. The previous year, the top five managers of Harvard Management Company, who were university employees, received a total of \$107.5 million. The two most successful

managers earned more than \$34 million each, while Mr. Meyer's own paycheck was \$6.9 million.<sup>51</sup>

A few Harvard alumni protested. Seven members of the class of 1969 wrote a letter to the university president calling the bonuses "unwarranted, inappropriate and contrary to the values of the university." One signer of the letter explained, "Our collective concern is that we think the amounts of money being paid to these folks are by almost any measure obscene."<sup>52</sup> They added, "Harvard should use its endowment for the benefit of students, not for the benefit of people who manage the endowment."<sup>53</sup> The alumni suggested that the millions of dollars paid to fund managers should be used instead to reduce tuition. Angry threats were made to withhold gifts to the university unless the compensation was reduced. The letter said, "Unless the University limits payments to financial managers to appropriate levels ... we see no reason why alumni should be asked for gifts."<sup>54</sup>

The compensation of the endowment fund managers far exceeded the salaries of Harvard faculty members and administrators, including the president, who made around half a million dollars. The 5-percent hike in tuition for Harvard students in 2004 was equal to the \$70 million paid to the two highest earners. One critic noted, "The managers of the endowment took home enough money last year to send more than 4,000 students to Harvard for a year."<sup>55</sup>

Although Harvard has the largest university endowment, the salaries and bonuses paid to the managers greatly exceeded the compensation paid at any other school. The head of Yale's third-place endowment was paid slightly over \$1 million in 2003.<sup>56</sup> However, Yale, like most universities, does not manage its investment fund in-house. When management of an endowment is outsourced, the managers are not university employees, and the fees paid to them, which may be as high as or even higher than those at Harvard, do not need to be reported.

Mr. Meyer and his team of managers have produced consistently superior returns for the Harvard endowment. Over a period of 14 years, he increased the endowment from \$4.7 billion to \$22.6 billion. Over the previous 10 years, the Harvard fund had an average return of 16.1 percent, which is far above the 12.5 percent return of the 25 largest endowments.<sup>57</sup> If the fund had produced average returns during this period, the endowment would have been one-half of what it was in 2004, which is a difference of almost \$9 billion. One person observed, "With results like that the alumni should be raising dough to put a statue of Jack Meyer in Harvard Yard, not taking potshots at him."<sup>58</sup> Mr. Meyer observed, "The letter [from members of the class of 1969] fails to recognize that there is a direct connection between bonuses and value added to Harvard. If you don't pay the \$17.5 million bonus, you don't get the approximately \$175 million in value added—so their math is a little perverse."<sup>59</sup> Moreover, the school's large

endowment is used in ways that benefit students. Endowment income covers 72 percent of undergraduate financial aid,<sup>60</sup> and the university charges no tuition to students from families earning less than \$60,000.<sup>61</sup> Harvard's immense endowment also enables the school to increase the faculty in growing areas and to expand its facilities.

In the end, Harvard decided to cap the compensation of fund managers. The result was that Jack Meyer and his team of managers left to start their own investment companies, at which many could earn 10 times their Harvard salary. Harvard Management Company also placed large amounts of endowment assets with these new firms. In so doing, it reduced the percentage of assets managed in-house and incurred the higher fees of outside managers, though they did not have to be reported. The university administration declined to defend its previous pay policy, which produced such stellar returns but drew considerable moral outrage. Business writer Michael Lewis speculates that Harvard's leaders were afraid to say what they thought. He observes, "We have arrived at a point in the money-management game where the going rate for the people who play it well is indefensible even to the people who understand it. No one wants to be seen thinking it is normal for someone to make US\$25-million a year."<sup>62</sup>

#### SHARED WRITING: LAVISH PAY AT HARVARD

Explain whether or not Harvard made the right choice in placing a limit on how much the fund managers could earn in-house. Consider whether the limits placed on compensation at Harvard also apply to the corporate world, and explain any differences that you see between the two situations.

Review and comment on at least two classmates' responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

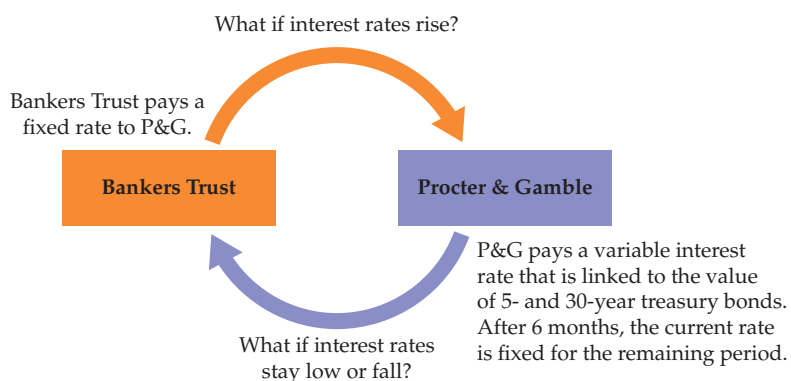
## Case: Broken Trust at Bankers Trust

Bankers Trust (now part of Deutsche Bank) was a leading seller of complex derivatives, which include futures, options, swaps, and other financial instruments whose value is based on (or derived from, hence the name "derivatives") other securities.<sup>63</sup> One Bankers Trust client was the consumer products giant Procter & Gamble (P&G), which used derivatives extensively. One type of derivative frequently used by P&G is an interest rate swap, in which the holder of, say, fixed interest bonds can

exchange the payment of a fixed rate of interest with another party and pay, in effect, a variable rate. The other party pays the fixed rate to the bondholder and accepts from the swapholder a variable rate. Such an agreement is beneficial to a company with bond obligations that carry a high fixed interest rate if it believes that interest rates will remain low or even fall, because it will pay less interest at a variable rate. However, the other side of the swap is betting that interest rates will rise, because, otherwise, it would lose money by paying a fixed rate in return for accepting a variable rate. An interest rate swap is a pure bet on the direction of interest rates.

In 1993, which was a time of low interest rates, P&G had a debt load of approximately \$5 billion. Of that debt, \$200 million of fixed interest bonds had been covered with an interest rate swap that was expiring, and P&G asked Bankers Trust for help in creating a new swap. After some negotiation, P&G accepted an offer from the bank to enter into a complicated swap in which the variable interest rate that P&G would pay would set in six months according to a complex formula (which Bankers Trust refused to reveal, claiming that it was proprietary) based on the difference or “spread” between 5-year and 30-year treasury bonds.<sup>64</sup> The formula “leveraged” the bet on interest rates since each percentage point rise in interest rates would result in a disproportionately large increase in the amount of variable interest paid by P&G. In two transactions, one on November 2, 1993, and the other on February 14, 2004, P&G entered into the swaps with Bankers Trust (see Figure 2.5 below).

**Figure 2.5** P&G’s “5–30” Swap Agreement with Bankers Trust



Trouble developed almost immediately when the Federal Reserve began raising interest rates. Although the six-month lock-in of interest rates had not yet occurred, the cost to P&G of getting out of the swaps had soared so that P&G’s borrowing costs would be increasing to more than 14 percent over the standard interest rate, costing the company approximately \$130 million in additional interest.

In a swap option, any loss to one party is a gain in the same amount to the other side of the bet. So a large loss at

P&G would result in a bonanza for Bankers Trust. Unlike several other Bankers Trust clients who claimed that they had been misled about the risks they were taking, P&G admitted that it knowingly took a great risk in betting that interest rates would not rise. Edwin L. Artz, the chairman of P&G, said, “The issue here is Bankers Trust’s selling practices.” He continued, “There’s a notion that end users of derivatives must be held accountable for what they buy. We agree completely, but only if the terms and risks are fully and accurately disclosed.”<sup>65</sup> Specifically, P&G felt it had been misled by assurances from Bankers Trust that it could get out of the swaps with little loss before the variable rate set in six months. Bankers Trust maintained that it had assured P&G that it would buy back the company’s swap position only at the current market rate as calculated by the bank. Every derivative has a current market value, and as a dealer in derivatives Bankers Trust stood ready to buy back any derivative it sold—but at the current market price, which might involve a considerable loss to the selling party. The bank denied that it had ever promised that it could limit P&G’s losses, which in any event would be impossible since the extent of any losses cannot be known in advance. Anyone dealing in options knows that no such assurance could be given. In the end, P&G was able to get out of the swaps but at a price of paying an interest rate of nearly 20 percent for four years.

The position of Bankers Trust was that it was merely a seller of a product that P&G wanted and that all appropriate disclosures had been made. In particular, the bank insisted that it was not a fiduciary with any obligation to protect P&G’s interest. P&G was a sophisticated investor that could understand the risks it was taking and determine its risk tolerance. Bankers Trust was not a trusted adviser in this instance but merely a trader. This position was compromised, however, by audio tapes that recorded conversations of Bankers Trust employees involved in the P&G transactions. (Most banks routinely record conversations in order to settle disputes over trades.) In discussing the swaps sold to P&G, one employee was recorded as saying, “They would never know. They would never know how much money was taken out of that.” To this, a colleague who agreed replied, “That’s the beauty of Bankers Trust.” Other comments include these: “This could be a massive huge future gravy train,” and “It’s like Russian roulette, and I keep putting another bullet in the revolver every time I do one of these.” A video of a training session recorded an instructor saying, “[W]hat Bankers Trust can do for [clients] is get in the middle and rip them off—take a little money.” It was alleged that employees at Bankers Trust used the acronym ROF for “rip-off factor” in their conversations and messages.



Bankers Trust denied that these taped conversations were representative of the culture at the bank, and a spokesperson said that “these stupid and crude comments . . . were the basis of disciplinary actions against these individuals last year.”

### SHARED WRITING: BROKEN TRUST AT BANKERS TRUST

Consider the relationship between Bankers Trust and Procter & Gamble (P&G). Did Bankers Trust have a duty to inform P&G of how it would be calculating rates to protect the company from losses, even though that would reduce its own profits? Or was P&G being a sore loser, having agreed to the terms of the swap deal despite the risks? Explain your reasoning.

Review and comment on at least two classmates’ responses, including one that opposes your own.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: KPMG’s Tax Shelter Business

In the 1990s, KPMG, one of the “big four” accounting firms, began offering tax shelters to corporations and wealthy investors. In addition to standard audit and consulting services, KPMG aggressively developed and marketed a number of innovative ways for clients to avoid taxes. Not only did individuals and businesses reduce taxes on billions of dollars of gains, but also KPMG partners pocketed many millions for their assistance.

Acting like any business developing a new product, KPMG established a “Tax Innovation Center” to generate ideas and to research the accounting, financial, and legal issues.<sup>66</sup> Previously, tax shelters had been individualized for particular clients, but the new ones were intended to be generic, mass-marketed products. Once a strategy was approved, it was energetically promoted to likely clients by the firm’s sales force. KPMG tax professionals were turned into salespeople. They were given revenue targets and urged to use telemarketing and the firm’s own confidential records to locate clients. The strategies—which bore such acronyms as OPIS, BLIPS, FLIP, and SOS—generally involved complicated investments with cooperating foreign and offshore banks that generated phantom losses that could be used to offset capital gains or income from other investments. The shelters were accompanied by opinion letters from law firms that assessed their legality. The gain to KPMG and its clients and the loss to the

U.S. Treasury were significant. The four main tax shelters marketed by the firm generated over \$11 billion in tax deductions for clients, which yielded at least \$115 million in fees for KPMG and cost the government \$2.5 billion in lost tax revenue.<sup>67</sup>

During the period in which the KPMG tax shelters were sold, no court or Internal Revenue Service (IRS) ruling had declared them illegal. However, KPMG had failed to register the shelters with the IRS as required by law. Registration alerts the tax authorities to the use of the shelters and permits them to investigate their legality. One KPMG partner attributed this failure to a lack of specific guidance by the IRS on the rules for registration and the agency’s lack of interest in enforcing the registration requirement.<sup>68</sup> Furthermore, this partner calculated that for OPIS, the firm would pay a penalty of only \$31,000 if the failure to register were discovered. This amount was more than outweighed by the fees of \$360,000 for each shelter sold.<sup>69</sup>

Until a court or Congress explicitly outlaws a tax shelter, the line between legal and illegal tax strategies is often difficult to draw. The IRS typically employs the “economic substance” test:

Do the transactions involved in a tax shelter serve a legitimate investment objective or is their only effect to reduce taxes?

A tax shelter that offers no return beyond a tax saving is abusive in the view of the IRS. However, an IRS ruling is not legally binding until it is upheld by the courts, and the courts have occasionally held some shelters to be legal even if they do not involve any risk or potential return. One reason for such decisions is that tax shelters typically involve legitimate transactions combined in unusual ways. As one observer notes, “Most abusive shelters are based on legal tax-planning techniques—but carried to extremes. That makes it hard to draw sharp lines between legitimate tax planning and illicit shelters.”<sup>70</sup> Even when a shelter like those sold by KPMG is found to be legal, a tax savings is almost always the only outcome. According to an IRS commissioner, “The only purpose of these abusive deals was to further enrich the already wealthy and to line the pockets of KPMG partners.”<sup>71</sup>

When a tax shelter is found by the court to be abusive, the usual outcome is simply a loss of the tax advantage so that the client pays what would be owed otherwise plus any penalties. The issuer is seldom sanctioned. KPMG and other marketers of tax shelters generally protect themselves, first, by having the client sign a statement affirming that he or she understands the structure of the transaction and believes that it serves a legitimate business purpose. This makes it more difficult for the client to sue the firm. KPMG also sent all related documents to its lawyers in order to protect them from disclosure by claiming lawyer-client privilege.

Although some partners at KPMG thought that the tax shelters were illegal and raised objections, others argued for their legality—and, in any event, their shelters were an immensely profitable part of the firm’s business. Aside from the huge fees, the motivation to market the shelters came from the KPMG culture, which *New York Times* business reporter Floyd Norris characterized as that of a “proud old lion.” He writes, “Of all the major accounting firms, it was the one with the strongest sense that it alone should determine . . . the rules it would follow. Proud and confident, it brooked no criticism from regulators.”<sup>72</sup>

### SHARED WRITING: KPMG’S TAX SHELTER BUSINESS



Which of the seven ethical principles discussed in this chapter was KPMG most guilty of violating? Explain the reasons for your response.

Review and comment on at least two classmates’ responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

### Chapter 2 Quiz: Ethical Decision Making

# Chapter 3

## Ethical Theories



### Learning Objectives

- 3.1** Describe the four theses of classical utilitarianism, the utilitarian approach to decision making, and the main criticisms of the cost–benefit analysis method
- 3.2** Summarize the two intuitive principles of Kantian ethics and their implications for moral reasoning
- 3.3** Define virtue and explain how virtues and principles of virtue ethics are relevant to business
- 3.4** Identify the meaning and importance of rights and the types of rights that apply in different situations
- 3.5** Explain the role of justice in business ethics, the three kinds of justice outlined by Aristotle, and the contemporary principles of justice offered by Rawls and Nozick

### Case: Big Brother at Procter & Gamble

In early August 1991, a former employee of Procter & Gamble telephoned *Wall Street Journal* reporter Alecia Swasy at her Pittsburgh office to report some disturbing news.<sup>1</sup> “The cops want to know what I told you about P&G,” he said. This 20-year veteran of the company had just been grilled for an hour by an investigator for the Cincinnati fraud squad. The investigator Gary Armstrong, who also happened to work part-time as a security officer for P&G, had records of the ex-manager’s recent long-distance calls, including some to Swasy.

Alecia Swasy had apparently angered CEO Edward Artz with two news stories about troubles at P&G that the company was not ready to reveal. An article in the *Wall Street Journal* on Monday, June 10, 1991, reported that B. Jurgen Hintz, executive vice president and heir apparent as CEO, had been forced to resign over difficulties in the food and beverage division. The next day, on Tuesday, June 11, a long article on the division’s woes quoted “current and former P&G managers” as saying that the company might sell certain product lines, including Citrus Hill orange juice, Crisco shortening, and Fisher nuts. Swasy believed that Artz had deliberately lied to her when she tried to confirm the story of Hintz’s departure in a telephone conversation

on Saturday, and that he tried to sabotage the *Journal* by allowing the news to be released to the rival *New York Times* and the Cincinnati newspapers in time for the Sunday editions while the public relations department continued to deny the story to Swasy.

Immediately after the two articles appeared in the *Wall Street Journal*, Artz ordered a search of P&G’s own phone records to determine the source of the leaks to the press. When this investigation failed to uncover any culprits, the company filed a complaint with the Hamilton County prosecutor’s office, which promptly opened a grand jury investigation. The grand jury then issued several subpoenas calling for Cincinnati Bell to search its records for all calls in the 513 and 606 area codes, which cover southern Ohio and northern Kentucky, and to identify all telephone calls to Alecia Swasy’s home or office and all fax transmissions to the newspaper’s Pittsburgh office between March 1 and June 15. The search combed the records of 803,849 home and business telephone lines from which users had placed more than 40 million long-distance calls.

P&G contended that it filed the complaint because of “significant and ongoing leaks of confidential business data, plans and strategies,” which included not only leaks to the news media but also leaks to competitors as well. The legal basis for the grand jury probe was provided by a 1967 Ohio law that makes it a crime to give away “articles representing trade secrets” and by a 1974 Ohio law that prohibits employees from disclosing “confidential information” without the permission of the employer. However,

reporters are generally protected by the First Amendment right of freedom of the press, and Ohio, Pennsylvania, and 24 other states have so-called “shield laws” that protect the identities of reporters’ confidential sources.

Information about an executive’s forced departure is scarcely a trade secret on a par with the formula for Crest toothpaste, and the use of the phrase “articles representing trade secrets” has been interpreted in the Ohio courts to mean documents such as photographs and blueprints, not word-of-mouth news. Any law that limits First Amendment rights must define the kind of speech prohibited and demonstrate a compelling need, but the 1974 law does not specify what constitutes confidential information or the conditions under which it is protected. Thus, some legal experts doubt the law’s constitutionality. P&G denied that any reporter’s First Amendment rights were being violated: “No news media outlet is being asked to turn over any names or any information. The investigation is focused on individuals who may be violating the law.”

### How do you think the public responded to P&G’s actions?

#### Compare Your Thoughts

The response to P&G’s role in the investigation was quick and angry. The Cincinnati chapter of the Society of Professional Journalists wrote, in a letter to CEO Artz, “The misguided

action Procter & Gamble is taking threatens to trample the First Amendment and obviously reflects more concern in identifying a possible leak within the company rather than protecting any trade secrets. . . . Your complaint has prompted a prosecutorial and police fishing expedition that amounts to censorship before the fact and could lead to further abuse of the First Amendment by other companies also disgruntled by news media coverage.” An editorial in the *Wall Street Journal* asked, “What possessed P&G?” and questioned the legality by saying, “We understand that P&G swings a big stick in Cincinnati, of course, and maybe the local law can, like Pampers, be stretched to cover the leak. It is not funny, though, to the folks being hassled by the cops.”

The sharpest criticism came from William Safire, the *New York Times* columnist, who objected to Edward Artz’s contention that P&G’s mistakes are not “an issue of ethics.” Safire concluded a column entitled “At P&G: It Sinks” with the words, “It’s not enough to say, ‘our leak hunt backfired, so excuse us’; the maker of Tide and Ivory can only come clean by showing its publics, and tomorrow’s business leaders, that it understands that abuse of power and invasion of privacy are no mere errors of judgment—regrettably inappropriate—but are unethical, bad, improper, wrong.”

In the end, no charges were filed against any individual, and the company continued to deny any wrongdoing. A spokesperson for P&G stated, “[The press] has the right to pursue information, but we have the right to protect proprietary information.” Fraud squad investigator Gary Armstrong later went to work for P&G full-time.

## Points to Consider...

Procter & Gamble’s heavy-handed investigation was undeniably a violation of several accepted business ethics principles. However, the critics of P&G did not cite any harmful consequences of the investigation beyond the chilling effect it might have had on employees and members of the press. They complained instead about the abuse of power and invasion of privacy. In particular, P&G was charged with violating certain rights—the right of reporters to search out newsworthy information and the right of ordinary citizens not to have their telephone records searched. Less certain is whether an employee has the right to disclose information to a reporter.

Consequences aside, however, there is something objectionable about a company snooping on its own employees and using law enforcement officials for company purposes. Although P&G’s conduct appears questionable, it is not easy to specify exactly the moral wrongs. Moreover, reasonable people might disagree about what is wrong in this case and on the more general issues involved. Our ordinary moral beliefs and the simple rules and principles of morality cannot settle all controversies that might arise from this and other cases.

When reasonable persons disagree about cases like these, we need to go beyond our conflicting positions and seek common ground in ethical theory. Put simply, the really

hard questions of ethics require that we think deeply and search out the best reasons available. For a fuller, more adequate understanding of ethical reasoning than that provided by the previously presented ethical framework, we may need the resources of the ethical theories that have been developed over the centuries by major moral philosophers.

It is customary initially to divide ethical theories into two types, usually called *teleological* and *deontological*. The most prominent historical examples of a teleological and a deontological theory are utilitarianism and the ethical theory of Immanuel Kant, respectively.

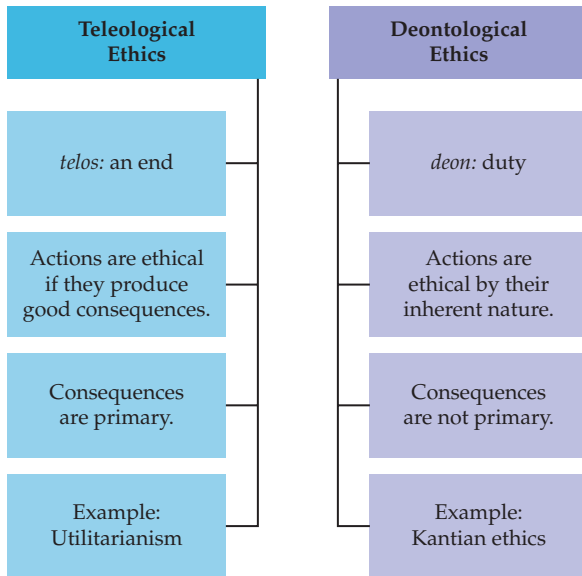
Teleological theories hold that the rightness of actions is determined solely by the amount of good consequences they produce. (The word “teleological” is derived from the Greek word “telos,” which means an end.) Actions are justified on teleological theories by virtue of the end they achieve, rather than some feature of the actions themselves.

Deontological theories, by contrast, deny that consequences are primary in determining what we ought to do. Deontologists typically hold that we have a duty to perform certain acts not because of some benefit to ourselves or others, but because of the nature of these actions or the inherent value of the principles from which they follow. (The word “deontological” is derived from “deon,” the Greek word for duty.) Thus, what makes lying wrong, a

deontologist would say, is the very nature of lying, not the consequences of lying. Other examples of nonconsequentialist reasoning in ethics include arguments based on principles such as the Golden Rule and those that appeal to basic notions of rights, human dignity, and respect for other persons.

The features of these two kinds of ethical theories are shown in Figure 3.1.

**Figure 3.1** What Actions Are Morally “Right”?



A third type of ethical theory identifies *virtue* as the key element and focuses less on right conduct and more on good character. Morality on this view is mainly about acquiring and practicing the character traits that conduce to a good life. Virtue ethics does not attempt to answer the central question of teleological and deontological theories about what makes actions right; rather, it asks how we can live a life of right action.

These theories are not only a valuable resource for enabling us to think through ethical issues in business but also the foundation for the ethics of business. The arguments that are presented in subsequent chapters about a wide range of business ethics issues all draw upon these various ethical theories. Some familiarity with these theories, then, will greatly improve the moral compass that we use to navigate the treacherous ethical terrain of the business world.

### WRITING PROMPT

#### Teleological, Deontological, and Virtue Ethics

Explain whether these three schools of thought seem equally valid. Which perspective do you adopt most often in your own life, and why?

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## 3.1: Utilitarianism

### 3.1 Describe the four theses of classical utilitarianism, the utilitarian approach to decision making, and the main criticisms of the cost–benefit analysis method

Different parts of the utilitarian doctrine were advanced by philosophers as far back as the ancient Greeks, but it remained for two English reformers in the nineteenth century to fashion them into a single coherent whole. The creators of classical utilitarianism were Jeremy Bentham (1748–1832) and John Stuart Mill (1806–1873), who lived in a turbulent era when England experienced some of the worst conditions of the Industrial Revolution. These were the conditions that moved Karl Marx to write *The Communist Manifesto*, and they were indelibly described by the poet William Blake as “these dark Satanic Mills.” In the hands of Bentham and Mill, utilitarianism was not an ivory-tower philosophy but a powerful instrument for social, political, economic, and legal change. Bentham and Mill used the principle of utility as a practical guide in the English reform movement.

### 3.1.1: Principle of Utility

Classical utilitarianism can be stated formally as follows:

An action is right if and only if it produces the greatest balance of pleasure over pain for everyone.

So stated, the utilitarian principle involves four distinct theses:

1. **Consequentialism.** The principle holds that the rightness of actions is determined solely by their consequences. It is by virtue of this thesis that utilitarianism is a teleological theory.
2. **Hedonism.** Utility in this statement of the theory is identified with pleasure and the absence of pain. Hedonism is the thesis that pleasure and only pleasure is ultimately good.
3. **Maximalism.** A right action is one that has not merely some good consequences but also the greatest amount of good consequences possible when the bad consequences are also taken into consideration.
4. **Universalism.** The consequences to be considered are those of everyone.

Consequentialism requires that the results or consequences of an act be measured in some way so that the good and bad consequences for different individuals can be computed and the results of different courses of action compared.

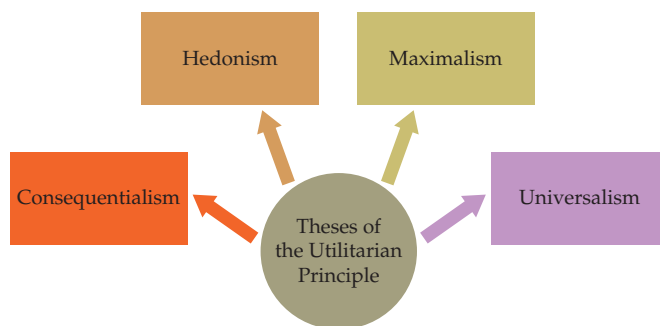
According to hedonism, the good and bad consequences to be considered are the pleasure and pain produced by an act. Virtually every act produces both pleasure and pain, and the principle of utility does not require that only pleasure and no pain result from a right action. An action may produce a great amount of pain and still be

right on the utilitarian view as long as the amount of pleasure produced is, on balance, greater than the amount of pleasure produced by any other action. Utilitarianism assumes that the amount of pain produced by an action can be subtracted from the amount of pleasure to yield the net amount of pleasure—in the same way that an accountant subtracts debts from assets to determine net worth.

The thesis of universalism requires us to consider the pleasure and pain of *everyone alike*. Thus, we are not following the principle of utility by considering the consequences only for ourselves, for our family and friends, or for an organization of which we are a part. Utilitarianism does not require us to ignore our own interest, but we are permitted to place it no higher and no lower than the interest of anyone else. The utilitarian principle does not insist that the interest of everyone be *promoted*, though. In deciding whether to close a polluting plant, for example, we need to consider the impact on everyone. No matter what decision is made, the interests of some people will be harmed. Utilitarian reasoning obligates us only to include the interests of everyone in our calculations, not to act in a way that advances every individual interest.

Use Figure 3.2 to review these four theses of utilitarianism.

**Figure 3.2** Four Distinct Theses of the Utilitarian Principle



The pleasure and pain of everyone must be given equal consideration.

### WRITING PROMPT

#### The Meaning of Utilitarianism

What problems might someone have with the four elements of utilitarianism? How might any one of these theses be modified to create a different form of utilitarianism?

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**ACT- AND RULE-UTILITARIANISM** In classical utilitarianism, an action is judged to be right by virtue of the consequences of performing *that action*. As a result, telling a lie or breaking a promise is right if it has better consequences

than any alternative course of action. Utilitarian morality thus seems to place no value on observing *rules*, such as “Tell the truth” or “Keep your promises,” except perhaps as “rules of thumb,” that is, as distillations of past experience about the tendencies of actions that eliminate the need to calculate consequences in every case.

This result can be avoided if we consider the consequences of performing not just particular actions but also *actions of a certain kind*. Although some instances of lying have consequences that are better than telling the truth, lying as a general practice does not. As a kind of action, then, truth-telling is right by virtue of the consequences of performing actions of that kind, and any instance of truth-telling is right because actions of that kind are right.

This suggestion leads to a distinction between two versions of utilitarianism, one in which we calculate the consequences of each act and another in which we consider the consequences of following the relevant rule. These two versions are called act-utilitarianism and rule-utilitarianism, respectively. They may now be expressed formally in the following way:

**An action is right if and only if**

- it produces the greatest balance of pleasure over pain for everyone. (Act-Utilitarianism)
- it conforms to a set of rules the general acceptance of which would produce the greatest balance of pleasure over pain for everyone.<sup>2</sup> (Rule-Utilitarianism)

Both act-utilitarianism and rule-utilitarianism have their merits, and there is no consensus among philosophers about which is correct.<sup>3</sup> Act-utilitarianism is a simpler theory and provides an easily understood decision procedure. Rule-utilitarianism seems to give firmer ground, however, to the rules of morality, which are problems for all teleological theories.

**CALCULATING UTILITY** There is little difficulty in calculating that some actions produce more pleasure for us than others. A decision to spend an evening at a concert is usually the result of a judgment that listening to music will give us more pleasure at that time than any available alternative. Confronted with a range of alternatives, we can usually rank them in order from the most pleasant to the least pleasant. A problem arises, however, when we attempt to determine exactly how *much* pleasure each course of action will produce, because pleasure cannot be measured precisely in terms of quantity, much less quality. Moreover, utilitarianism requires that we calculate utility not only for ourselves but also for all persons affected by an action.

Some critics contend that this requirement imposes an information burden on utilitarian decision makers that is difficult to meet. In order to buy a gift for a friend that will produce the greatest amount of pleasure, for example, we

need to know something about that person's desires and tastes. Consider, for example, the task faced by a utilitarian legislator who must decide whether to permit logging in a public park. This person must identify all the people affected, determine the amount of pleasure and pain for each one, and then compare the pleasure that hiking brings to nature lovers versus the pain that would be caused to loggers if they lost their jobs. The abilities of ordinary human beings are inadequate, critics complain, to acquire and process the vast amount of relevant information in such a case. The response of utilitarians to these problems is that we manage in practice to make educated guesses by relying on past experience and limiting our attention to a few salient aspects of a situation.

Comparing the pleasure and pain of different people raises a further problem about the *interpersonal comparison of utility*. Imagine two people who each insists after attending a concert that he or she enjoyed it more. There seems to be no way in principle to settle this dispute. Some philosophers and economists consider this problem to be insoluble and a reason for rejecting utilitarianism both as an ethical theory and as a basis for economics.<sup>4</sup> Others argue for the possibility of interpersonal comparisons on the basis that regardless of whether we can make such comparisons precisely, we do make them in everyday life with reasonable confidence.<sup>5</sup> We may give away an extra ticket to a concert, for example, to the friend we believe will enjoy it the most based on past experience. The problem of the interpersonal comparison of utility is not insuperable, therefore, as long as rough comparisons are sufficient for utilitarian calculations.

### WRITING PROMPT

#### Utilitarianism in Action

What are the problems with trying to objectively compare, or quantify, pleasure and pain? Think of the number scale doctors ask patients to use to describe the level of physical pain they are feeling. On this scale, 0 represents no pain and 10 represents pain so intense it causes the patient to lose consciousness. Why couldn't a similar system be used to quantify the consequences of an act for both pleasure and pain?

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## 3.1.2: Cost–Benefit Analysis

The utilitarian ideal of a precise quantitative method for decision making is most fully realized in *cost–benefit analysis*. This method differs from classical utilitarianism, with its measure of pleasure and pain, primarily in the use of monetary units to express the consequences of various alternatives. Any project in which the dollar amount of the benefits exceeds the dollar amount of the costs is worth

pursuing, according to cost–benefit analysis, and from among different projects, the one that promises the greatest net benefit, as measured in dollars, ought to be chosen.<sup>6</sup>

The chief advantage of cost–benefit analysis is that the prices of many goods are set by the market, so that the need to have knowledge of people's pleasures or preferences is largely eliminated. The value of different goods is easily totaled to produce a figure that reflects the costs and benefits of different courses of action for all concerned. Money also provides a common denominator for allocating resources among projects that cannot easily be compared otherwise. Would scarce resources be better spent on preschool education, for example, or on the development of new sources of energy? In cost–benefit analysis, decision makers have an analytic framework that enables them to decide among such disparate projects in a rational, objective manner.

**EVALUATION OF COST–BENEFIT ANALYSIS** Cost–benefit analysis is criticized for problems with assigning monetary values to costs and benefits. **First, not all costs and benefits have an easily determined monetary value.** The value of the jobs that are provided by logging on public land can be expressed precisely in dollars, as can the value of the lumber produced. But because the opportunity for hikers to enjoy unspoiled vistas and fresh-smelling air is not something that is commonly bought and sold, it has no established market price. Experts in cost–benefit analysis attempt to overcome the problem of assigning a dollar figure to nonmarket goods with a technique known as *shadow pricing*. This consists of determining the value reflected by people's market and nonmarket behavior. For example, by comparing the prices of houses near airports, busy highways, and the like with the prices of similar houses in less noisy areas, it is possible to infer the value that people place on peace and quiet. The value of life and limb can be similarly estimated by considering the amount of extra pay that is needed to get workers to accept risky jobs.

There are some pitfalls in using the technique of shadow pricing, especially when human life is involved. Many people buy houses in noisy areas or accept risky jobs because they are unable to afford decent housing anywhere else or to secure safer employment. Some home buyers and job seekers may not fully consider or appreciate the risks they face, especially when the hazards are hidden or speculative. Also, the people who buy homes near airports or accept work as steplejacks are possibly less concerned with noise or danger than is the general population. We certainly do not want to assume, however, that workplace safety is of little value simply because a few people are so heedless of danger that they accept jobs that more cautious people avoid.<sup>7</sup>

**A second criticism of cost–benefit analysis is that some applications require that a value be placed on human life.** Although this may seem heartless, it is necessary if cost–benefit analysis is to be used to determine how much to

spend on prenatal care to improve the rate of infant mortality, for example, or on reducing the amount of cancer-causing emissions from factories. Reducing infant mortality or the death rate from cancer justifies the expenditure of some funds, but how much? Would further investment be justified if it reduced the amount available for education or the arts? No matter where the line is drawn, some trade-off must be made between saving lives and securing other goods. The purpose of assigning a monetary value to life in a cost-benefit analysis is not to indicate how much a life is actually worth but to enable us to compare alternatives where life is at stake. Several methods exist, in fact, for calculating the value of human life for purposes of cost-benefit analysis.<sup>8</sup> Among these are the discounted value of a person's future earnings over a normal lifetime, the value that existing social and political arrangements place on the life of individuals, and the value that is revealed by the amount that individuals are willing to pay to avoid the risk of injury and death. When people choose through their elected representatives or by their own consumer behavior not to spend additional amounts to improve automobile safety, for example, they implicitly indicate the value of the lives that would otherwise be saved. Using such indicators, economists calculate that middle-income Americans value their lives between \$3 million and \$5 million.<sup>9</sup> Experts in risk assessment calculate that the "break-even" point where the amount expended to save a life is worth the cost is about \$10 million.<sup>10</sup>

**Third, people's individual and collective decisions are not always rational.** People who drive without seat belts are probably aware of their benefit *for other people* but are convinced that nothing will happen *to them* because they are such good drivers.<sup>11</sup> As a result, they (irrationally) expose themselves to risks that do not accurately reflect the value they place on their own lives. Mark Sagoff observes that the choices we make as consumers do not always correspond to those we make as citizens. He cites as examples the fact that he buys beverages in disposable containers but urges his state legislators to require returnable bottles and that he has a car with an "Ecology Now" sticker that leaks oil everywhere it is parked.<sup>12</sup>

**ASSIGNING MONETARY VALUES** A further criticism of cost-benefit analysis is that even if all the other problems

with assigning monetary values could be solved, there are still good reasons for not assigning a monetary value to some things. Steven Kelman argues that placing a dollar value on some goods reduces their perceived value because they are valued precisely because they cannot be bought and sold in a market. Friendship and love are obvious examples. "Imagine the reaction," Kelman observes, "if a practitioner of cost-benefit analysis computed the benefits of sex based on the price of prostitute service."<sup>13</sup> In *The Gift Relationship: From Human Blood to Social Policy*, Richard M. Titmuss compares the American system of blood collection with that of the British. In the United States, about half of all blood is purchased from donors and sold to people who need transfusions.<sup>14</sup> The British system, by contrast, is purely voluntary. No one is paid for donating blood, and it is provided without charge to anyone in need. As a result, the giving of blood and the receipt of blood have an entirely different significance. If blood has a price, then giving blood merely saves someone else an expense, but blood that cannot be bought and sold becomes a special gift that we make to others.<sup>15</sup>

Although some things are cheapened in people's eyes if they are made into commodities and traded in a market, this does not happen if goods are assigned a value merely for purposes of comparison. It is the actual buying and selling of blood that changes its perceived value, not performing a cost-benefit analysis. Moreover, Titmuss himself argues in favor of the British system on the grounds that the system in the United States is

1. highly wasteful of blood, resulting in chronic acute shortages;
2. administratively inefficient because of the large bureaucracy that it requires;
3. more expensive (the price of blood is 5 to 15 times higher); and
4. more dangerous because there is a greater risk of disease and death from contaminated blood.<sup>16</sup>

In short, a cost-benefit analysis shows that it is better not to have a market for blood.

Use Table 3.1 to review the pros and cons of cost-benefit analysis as a quantitative method for decision making.

**Table 3.1** Pros and Cons of Cost-Benefit Analysis

Review the main pros and cons for each point given in the left column. Then hide the cells to quiz yourself.

	Pros	Cons
<b>Consequences measured by monetary value in a market</b>	The market price or value of goods and services can be used to compare outcomes.	Not all costs and benefits have a discernible market value or can be objectively valued.
<b>Shadow pricing of nonmarket goods</b>	Market value can be estimated by analyzing the relative worth of choices suggested by actual behavior.	Not all people are able to act or choose in accordance with their preferences, or make rational decisions.
<b>Placing a value on human life and experiences</b>	Can apply cost-benefit analysis to issues such as human health and safety	Seems cold-hearted and reductive; life, love, happiness, etc. cannot be bought and are cheapened by assigned values



## WRITING PROMPT

### Conducting a Cost–Benefit Analysis

Your city council is considering a law to raise the local minimum wage paid to all employees. Many local businesses are concerned that such a measure would significantly increase the costs of doing business. How could your city council use cost–benefit analysis to decide whether to raise the minimum wage law and, if so, by how much?

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## 3.2: Kantian Ethics

### 3.2 Summarize the two intuitive principles of Kantian ethics and their implications for moral reasoning

Immanuel Kant (1724–1804) wrote his famous ethical treatise *Foundations of the Metaphysics of Morals* (1785) before the rise of English utilitarianism, but he was well acquainted with the idea of founding morality on the feelings of pleasure and pain, rather than on reason. Accordingly, Kant set out, in the spirit of the Enlightenment, to restore reason to what he regarded as its rightful place in our moral life. Specifically, he attempted to show that there are some things that we ought to do and others that we ought not to do merely by virtue of being rational. Moral obligation thus is not based on maximizing consequences, in Kant’s view, but arises solely from a moral law that is binding on all rational beings. Although Kant’s own expression of his theory is difficult to understand, the main thrust can be formulated in two intuitive principles: universalizability and respect for persons.

### 3.2.1: Universalizability

The universalizability principle can be illustrated by one of Kant’s own examples:

[A] man finds himself forced by need to borrow money. He well knows that he will not be able to repay it, but he also sees that nothing will be loaned him if he does not firmly promise to repay it at a certain time. He desires to make such a promise, but he has enough conscience to ask himself whether it is not improper and opposed to duty to relieve his distress in such a way.

What (morally) ought this man to do? A teleological theory would have us answer this question by determining the consequences of each alternative course of action, but Kant regarded all such appeals to consequences as morally irrelevant. As a deontologist, he held that the duty to tell the truth when making promises arises from a rule that ought to be followed without regard for consequences. Even if the man could do more good by borrowing money

under false pretenses—by using it to pay for an operation that would save a person’s life, for example—the action would still be wrong. (See *What Actions Are Morally “Right”?* to review the difference between teleological and deontological perspectives.)

Kant addressed the problem of making a lying promise with a principle that he called the *categorical imperative*. His own cryptic statement of the categorical imperative is as follows:

Act only according to that maxim by which you can at the same time will that it should become a universal law.

Rendered into more comprehensible English, Kant’s principle is, act only on rules (or maxims) that you would be willing to have everyone follow. The categorical imperative suggests a rather remarkable “thought experiment” to be performed whenever we deliberate about what to do. Suppose, for example, that every time we accept a rule for our own conduct, that very same rule would be imposed, by some miracle, on everyone. We would become, in other words, a universal rule maker. Under such conditions, are there some rules that we, as rational beings, simply could not accept (that is, will to become universal law)?

Applying this thought experiment to Kant’s example, if the man were to obtain the loan under false pretenses, the rule on which he would be acting might be formulated as: Whenever you need a loan, make a promise to repay the money, even if you know that you cannot do so. Although one person could easily act on such a rule, the effect of its being made a rule for everyone universally would be, in Kant’s view, self-defeating. No one would believe anyone else, and the result would be that the phrase “I promise to do such-and-such” would lose its meaning. To Kant’s own way of thinking, the objection to the rule just stated is not that everyone’s following it would lead to undesirable consequences—that would be utilitarianism—but that everyone’s following it describes a logically impossible state of affairs. Willing that everyone act on this rule is analogous to a person making plans to vacation in two places, say Acapulco and Aspen, *at the same time*. A person could will to go to either place, but willing the logical impossibility of being in two places at once is not something that a rational person could will to do.

Regardless of whether Kant is successful in his attempt to show that immoral conduct is somehow irrational, many philosophers still find a kernel of truth in Kant’s principle of the categorical imperative, which they express as the claim that all moral judgments must be *universalizable*. That is, if we say that an act is right for one person, then we are committed to saying, as a matter of logical consistency, that it is right for all other relevantly similar persons in relevantly similar circumstances. By the same token, if an act is wrong for other people, then it is wrong for any one person unless there is some difference that justifies making an

exception. This *principle of universalizability* expresses the simple point that, as a matter of logic, we must be consistent in the judgments we make.

The principle of universalizability has immense implications for moral reasoning.

**1. First, it counters the natural temptation to make exceptions for ourselves or to apply a double standard.**

**Example:** Consider a job applicant who exaggerates a bit on a résumé but is incensed to discover, after being hired, that the company misrepresented the opportunity for advancement. The person is being inconsistent to hold that it is all right for him to lie to others but wrong for anyone else to lie to him. An effective move in a moral argument is to challenge people who hold such positions to cite some morally relevant difference. Why is lying right in the one case and wrong in the other? If they can offer no answer, then they are forced by the laws of logic to give up one of the inconsistent judgments. The principle of universalizability counters the natural temptation to make exceptions for ourselves or to apply a double standard.

**2. The universalizability principle can be viewed as underlying the common question, “What if everyone did that?”**

**Example:** The consequences of a few people cheating on their taxes are negligible. If everyone were to cheat, however, the results would be disastrous. The force of “What if everyone did that?” is to get people to see that because it would be undesirable for everyone to cheat, no one ought to do so. This pattern of ethical reasoning involves an appeal to consequences, but it differs from standard forms of utilitarianism in that the consequences are hypothetical rather than actual. That is, whether anyone else actually cheats is irrelevant to the question, “What if everyone did that?” The fact that the results would be disastrous if everyone did is sufficient to entail the conclusion that cheating is wrong because an individual cannot rationally accept those results.

### 3.2.2: Respect for Persons

Kant offered a second formulation of the categorical imperative, which he expressed as follows:

Act so that you treat humanity, whether in your own person or that of another, always as an end and never as a means only.

These words are usually interpreted to mean that we should respect other people (and ourselves!) as human beings. The kind of respect that Kant had in mind is compatible with achieving our ends by enlisting the aid of other people. We use shop clerks and taxi drivers, for example, as a means for achieving our ends, and the owners of a business

use employees as a means for achieving their ends. What is ruled out by Kant’s principle, however, is treating people *only* as a means, so that they are no different, in our view, from mere “things.”

In Kant’s view, what is distinctive about human beings, which makes them different from “things” or inanimate objects, is the possession of reason, and by reason Kant means the ability to posit ends and to act purposefully to achieve them. In acting to achieve ends, human beings also have free will that enables them to create rules to govern their own conduct. This idea of acting on self-devised rules is conveyed by the term *autonomy*, which is derived from two Greek words meaning “self” and “law.” To be autonomous is quite literally to be a law-giver to oneself, or self-governing. A rational being, therefore, is a being who is autonomous. To respect other people, then, is to fully respect their capacity for acting freely, that is, their autonomy. When individuals are deceived, seriously harmed, or treated unfairly their autonomy is disrespected.

Kant’s ethical theory thus yields at least two important results: the principles of universalizability and respect for persons, which are important elements of ethical reasoning that serve as alternatives to, or perhaps as valuable additions to, the utilitarian approach.

#### WRITING PROMPT

##### A Kantian Thought Experiment

Describe a few examples of unethical behavior in business that you have witnessed or experienced. How do these examples fail to meet Kant’s universalizability principle? How do they fail to demonstrate respect for human beings?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 3.3: Virtue Ethics

### 3.3 Define virtue and explain how virtues and principles of virtue ethics are relevant to business

Despite their differences, utilitarianism and Kantian ethics both address the question, “What actions are right?” Virtue ethics asks instead,

“What kind of person should we be?”

Moral character rather than right action is fundamental in this ethical tradition, which originated with the ancient Greeks and received its fullest expression in Aristotle’s *Nicomachean Ethics*. The role of ethics according to Aristotle is to enable us to lead successful, rewarding lives—the kinds of lives that we would call “the good life.” The good life in Aristotle’s sense is possible only for

virtuous persons—that is, persons who develop the traits of character that we call “the virtues.” Aristotle not only made the case for the necessity of virtue for good living but also described particular virtues in illuminating detail.

### 3.3.1: What Is Virtue?

Defining virtue has proven to be difficult, and philosophers are by no means in agreement.<sup>18</sup>

- Aristotle described virtue as a character trait that manifests itself in habitual action. Honesty, for example, cannot consist in telling the truth once; it is rather the trait of a person who tells the truth as a general practice. Only after observing people over a period of time can we determine whether they are honest. Mere feelings like hunger are not virtues, according to Aristotle, in part because virtues are *acquired* traits. A person must *become* honest through proper upbringing.
- A virtue is also something that we actually *practice*. Honesty is not simply a matter of knowing how to tell the truth but involves habitually telling the truth and possessing the attitudes that unconditionally support honest behavior. For these reasons, Aristotle classified virtue as a *state* of character, which is different from a feeling or a skill.
- Finally, a virtue is something that we *admire* in a person; a virtue is an excellence of some kind that is worth having for its own sake. A skill like carpentry is useful for building a house, for example, but everyone need not be a carpenter. Honesty, by contrast, is a trait that everyone needs for a good life.

A complete definition of virtue must be even more encompassing because a compassionate person, for example, must have certain kinds of feelings at the distress of others and also the capacity for sound, reasoned judgments in coming to their aid. Virtue, for Aristotle, is integrally related to what he calls *practical wisdom*, which may be described roughly as the whole of what a person needs in order to live well. Being wise about how to live involves more than having certain character traits, but being practically wise and exhibiting virtue are ultimately inseparable. Although the problems of defining virtue are important in a complete theory of virtue ethics, the idea of virtue as a trait of character that is essential for leading a successful life is sufficient for our purposes.

Most lists of the virtues contain few surprises. Such traits as benevolence, compassion, courage, courtesy, dependability, friendliness, honesty, loyalty, moderation, self-control, and toleration are most often mentioned. Aristotle also considered both pride and shame to be virtues on the grounds that we should be proud of our genuine accomplishments (but not arrogant) and properly shamed by our failings. More significantly, Aristotle lists

justice among the virtues. A virtuous person not only has a sense of fair treatment but can also determine what constitutes fairness.

### 3.3.2: Defending the Virtues

Defending any list of the virtues requires consideration of the contribution that each character trait makes to a good life. In particular, the virtues are those traits that everyone needs for the good life irrespective of his or her specific situation. Thus, courage is a good thing for anyone to have because perseverance in the face of dangers will improve our chances of getting whatever it is we want. Similarly, Aristotle’s defense of moderation as a virtue hinges on the insight that a person given to excess will be incapable of effective action toward any end. Honesty, too, is a trait that serves everyone well because it creates trust, without which we could not work cooperatively with others.

What is the good life, the end for which the virtues are needed?

In defending a list of virtues, we cannot consider merely their contribution to some end, however; we must also inquire into the end itself. If our conception of a successful life is amassing great power and wealth, for example, then would not ruthlessness be a virtue? A successful life of crime or lechery requires the character of a Fagin or a Don Juan, but we scarcely consider their traits to be virtues—or Fagin and Don Juan to be virtuous characters. The “end” of life—that at which we all aim, according to Aristotle—is *happiness*, and Aristotle would claim that no despot or criminal or lecher can be happy, no matter how successful such a person may be in these (disreputable) pursuits. Defending any list of virtues requires, therefore, that some content be given to the idea of a good life.

The virtues, moreover, are not merely means to happiness but are themselves constituents of it. That is, happiness does not consist solely of what we get in life but also includes who we are. A mother or a father, for example, cannot get the joy that comes from being a parent without actually having the traits that make one a good parent. Similarly, Aristotle would agree with Plato that anyone who became the kind of person who could be a successful despot, for example, would thereby become incapable of being happy because that person’s personality would be disordered in the process.

To summarize, defending a list of the virtues requires both that we determine the character traits that are essential to a good life and that we give some content to the idea of a good life itself. Virtue ethics necessarily presupposes a view about human nature and the purpose of life. This point is worth stressing because the possibility of applying virtue ethics to business depends on a context that includes some conception of the nature and purpose of business.

### 3.3.3: Virtue in Business

Virtue ethics could be applied to business directly by holding that the virtues of a good businessperson are the same as those of a good person (period). Insofar as business is a part of life, why should the virtues of successful living not apply to this realm as well? However, businesspeople face situations that are peculiar to business, and so they may need certain business-related character traits. Some virtues of everyday life, moreover, are not wholly applicable to business.

#### What virtues have limited application in business?

##### Two examples are compassion and honesty.

Any manager should be caring, for example, but a concern for employee welfare can go only so far when a layoff is unavoidable. Honesty, too, is a virtue in business, but a certain amount of bluffing or concealment is accepted and perhaps required in negotiations.

Regardless of whether the ethics of business is different from that of everyday life, we need to show that virtue ethics is relevant to business by determining the character traits that make for a good businessperson.

Applying virtue ethics to business would require us, first, to determine the end at which business activity aims. If the purpose of business is merely to create as much wealth as possible, then we get one set of virtues. Robert C. Solomon, who develops a virtue ethics–based view of business in his book *Ethics and Excellence*, argues that mere wealth creation is not the purpose of business. Rather, a virtue approach, according to Solomon, considers business as an essential part of the good life.<sup>19</sup>

Solomon contends that individuals are embedded in communities and that business is essentially a communal activity, in which people work together for a common good. For individuals, this means achieving a good life that includes rewarding and fulfilling work, and excellence for a corporation consists of making the good life possible for everyone in society. Whether any given character trait is a virtue in business, then, is to be determined by the purpose of business and by the extent to which that trait contributes to that purpose. Virtues and vices in business also depend on the character traits that enable or hinder a person in the performance of specific jobs, as illustrated in Table 3.2.

**Table 3.2** Virtues and Vices in Business

For each job listed in the table, what character trait(s) might be considered a virtue? In contrast, what trait might be a vice, or a trait that might hinder the job holder's ability to do the job well?

Hide the cells to come up with your own suggestions. Then click each cell to see the provided examples.

Job	Virtue	Vice
Bank loan officer	Prudence, Caution	Charity
School guidance counselor	Empathy, Enthusiasm	Indifference
Personnel manager	Resourcefulness, Impartiality	Prejudice
Corporate executive	Confidence, Focus	Arrogance

### WRITING PROMPT

#### Virtues as Job Requirements

Suppose that those who are happy with their jobs also perform well in them because they are personally suited for the role. Now think of a career you have considered for yourself. What character traits would a person need to excel in that job or field?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 3.4: Rights

### 3.4 Identify the meaning and importance of rights and the types of rights that apply in different situations

Rights play an important role in business ethics and, indeed, in many ethical issues in society. Both employers and employees are commonly regarded as having certain rights. Employers have the right to conduct business as they see fit, to make decisions about hiring and promotion, and to be protected against unfair forms of competition. Employees have the right to organize and engage in collective bargaining and to be protected against discrimination and hazardous working conditions. Consumers and the general public also have rights in such matters as marketing and advertising, product safety, and the protection of the environment. Some American manufacturers have been accused of violating the rights of workers in developing countries by offering low wages and substandard working conditions.

#### 3.4.1: Meaning of Rights

The introduction of rights into the discussion of ethical issues is often confusing.

1. First, the term *rights* is used in many different ways, so that the concept of a right and the various kinds of rights must be carefully distinguished.
2. Second, many rights come into conflict. The right of an employee to leave his or her employer and join a competitor conflicts with the legitimate right of employers to protect trade secrets, for example, so that some balancing is required.
3. Third, because of the moral significance that we attach to rights, there is a tendency to stretch the concept in ways that dilute its meaning. For example, the rights to receive adequate food, clothing, and medical care, mentioned in the Universal Declaration of Human Rights, are perhaps better described as political goals rather than moral rights.
4. Fourth, there can be disagreement over the very existence of a right. Whether employees have a right to due process in discharge decisions, for example, is a subject of dispute.

For all these reasons, the claim of a right is frequently the beginning of an ethical debate rather than the end.

The concept of a right can be explained by imagining a company that treats employees fairly but does not recognize due process as a right.<sup>20</sup> In this company, employees are dismissed only for good reasons after a thorough and impartial hearing, but there is no contract, statute, or other provision establishing a right of due process for all employees. Something is still missing, because the fair treatment that the employees enjoy results solely from the company's voluntary acceptance of certain personnel policies. If the company were ever to change these policies, then employees dismissed without due process would have no recourse. We can contrast this with a company in which due process is established as a right. Employees in this company have something that was lacking in the previous company. They have an independent basis for challenging a decision by the company to dismiss them. They have something to stand on, namely, their rights.

Rights can be understood, therefore, as *entitlements*.<sup>21</sup> To have rights is to be entitled to act on our own or to be treated by others in certain ways without asking permission of anyone or being dependent on other people's goodwill. Rights entitle us to make claims on other people either to refrain from interfering in what we do or to contribute actively to our well-being—not as beggars, who can only entreat others to be generous, but as creditors, who can demand what is owed to them. This explanation of rights in terms of entitlements runs the risk of circularity (after all, what is an entitlement but something we have a right to?), but it is sufficiently illuminating to serve as a beginning of our examination.

### 3.4.2: Kinds of Rights

Several kinds of rights have been distinguished.

1. **Legal and Moral Rights.** *Legal rights* are rights that are recognized and enforced as part of a legal system. In the United States, these consist primarily of the rights set forth in the Constitution, including the Bill of Rights, and those created by acts of Congress and state legislatures. *Moral rights*, by contrast, are rights that do not depend on the existence of a legal system. They are rights that we (morally) *ought* to have, regardless of whether they are explicitly recognized by law. Moral rights derive their force not from being part of a legal system but from more general ethical rules and principles.
2. **Specific and General Rights.** Some rights are *specific* in that they involve identifiable individuals. A major source of specific rights is contracts because these ubiquitous instruments create a set of mutual rights as well as duties for the individuals who are parties to them. Other rights are *general* rights because they involve claims against

everyone, or humanity in general. Thus, the right to free speech belongs to everyone, and the obligation to enforce this right rests with the whole community.

3. **Negative and Positive Rights.** Generally, *negative* rights are correlated with obligations on the part of others to refrain from acting in certain ways that interfere with our own freedom of action. *Positive* rights, by contrast, impose obligations on other people to provide us with some good or service and thereby to act positively on our behalf.<sup>22</sup> The right to property, for example, is largely a negative right because no one else is obligated to provide us with property, but everyone has an obligation not to use or take our property without permission. The right to adequate health care, for example, is a positive right insofar as its implementation requires others to provide the necessary resources.
4. **Natural Rights.** Among the moral rights that are commonly recognized, one particular kind that is prominent in historical documents is *natural rights*, which are thought to belong to all persons purely by virtue of their being human.<sup>23</sup> Natural rights are characterized by two main features: *universality* and *unconditionality*. Universality means that they are possessed by all persons, without regard for race, sex, nationality, or any specific circumstances of birth or present condition. Unconditionality means that natural or human rights do not depend on any particular practices or institutions in society. The unconditionality of rights also means that there is nothing we can do to relinquish them or to deprive ourselves or others of them. This feature of natural, or human, rights is what is usually meant by the phrase *inalienable rights*, which is used in the American *Declaration of Independence*.<sup>24</sup>

The most prominent natural rights theory is that presented by John Locke (1633–1704) in his famous *Second Treatise of Government* (1690).<sup>25</sup> Locke began with the supposition of a state of nature, which is the condition of human beings in the absence of any government. The idea is to imagine what life would be like if there were no government and then to justify the establishment of a political state to remedy the defects of the state of nature. Locke held that human beings have rights, even in the state of nature, and that the justification for uniting into a state is to protect these rights. The most important natural right for Locke is the right to property. In his view, although the bounty of the earth is provided by God for the benefit of all, no one can make use of it without taking some portion as one's own. This is done by means of labor, which is also a form of property. "Every man has property in his own person," according to Locke, and so "[t]he labor of his body and the work of his hands . . . are properly his."

Use Figure 3.3 to review key points about the different kinds of rights discussed.

**Figure 3.3** Different Kinds of Rights

Legal and Moral Rights	Specific and General Rights	Negative and Positive Rights	Natural Rights (“Human Rights”)
<ul style="list-style-type: none"> <li>• Legal rights are recognized and protected by law.</li> <li>• Moral rights are derived from ethical principles.</li> <li>• In the United States, certain moral rights did not become legal rights until after slavery was abolished and civil rights laws were passed.</li> </ul>	<ul style="list-style-type: none"> <li>• Specific rights are those given to, or claimed by, particular individuals.</li> <li>• General rights apply to everyone.</li> </ul>	<ul style="list-style-type: none"> <li>• Negative rights prohibit actions, or call for people to refrain from acting in a certain way.</li> <li>• Positive rights require actions; they call on people to fulfill an obligation to provide some good or service.</li> </ul>	<ul style="list-style-type: none"> <li>• Natural rights are universal and unconditional from birth and need not be recognized by one’s culture or legal system.</li> <li>• In the United States, the moral right to equal protection of the laws did not become a legal right until the adoption of the Fourteenth Amendment to the Constitution.</li> </ul>

**WRITING PROMPT****Rights in Business**

What right do you think is most often neglected or violated in the employment relationship? Give an example, identify what type of right it is, and explain what entitlement it grants to employers or employees.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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The concept of justice is relevant to business ethics primarily in the distribution of benefits and burdens. Economic transformations often involve an overall improvement of welfare that is unevenly distributed, so that some groups pay a price while others reap the rewards. Is the resulting distribution just, and if not, is there anything that is owed to the losers? Justice also requires that something be done to compensate the victims of discrimination or defective products or industrial accidents. Because justice is also an important concept in evaluating various forms of social organization, we can also ask about the justice of the economic system in which business activity takes place.

## 3.5: Justice

### 3.5 Explain the role of justice in business ethics, the three kinds of justice outlined by Aristotle, and the contemporary principles of justice offered by Rawls and Nozick

Justice, like rights, is an important moral concept with a wide range of applications. We use it to evaluate not only the actions of individuals but also social, legal, political, and economic practices and institutions. Questions of *justice* or *fairness* (the two terms are used here interchangeably) often arise when there is something to distribute. If there is a shortage of organ donors, for example, we ask, what is a just or fair way of deciding who gets a transplant? If there is a burden, such as taxes, we want to make sure that everyone bears a fair share. Justice is also concerned with the righting of wrongs. It requires, for example, that a criminal be punished for a crime and that the punishment fit the crime by being neither too lenient nor too severe. To treat people justly is to give them what they deserve, which is sometimes the opposite of generosity and compassion. Indeed, we often speak of tempering justice with mercy.

### 3.5.1: Nature and Value of Justice

The ancient Greek philosopher Aristotle distinguished three kinds of justice.

1. *Distributive justice*, which deals with the distribution of benefits and burdens.
2. *Compensatory justice*, which is a matter of compensating persons for wrongs done to them.
3. *Retributive justice*, which involves the punishment of wrongdoers.

Both compensatory and retributive justice are concerned with correcting wrongs. Generally, compensating the victims is the just way of correcting wrongs in private dealings, such as losses resulting from accidents and the failure to fulfill contracts, whereas retribution—that is, punishment—is the just response to criminal acts, such as assault or theft.<sup>26</sup>

Questions about distributive justice arise mostly in the evaluation of our social, political, and economic institutions, where the benefits and burdens of engaging in cooperative activities must be spread over a group. In some

instances, a just distribution is one in which each person shares equally, but in others, unequal sharing is just if the inequality is in accord with some principle of distribution. Thus, in a graduated income tax system, ability to pay and not equal shares is the principle for distributing the burden. Generally, distributive justice is *comparative*, in that it considers not the absolute amount of benefits and burdens of each person but each person's amount relative to that of others.<sup>27</sup> Whether income is justly distributed, for example, cannot be determined by looking only at the income of one person but requires us, in addition, to compare the income of all people in a society.

The rationale of compensatory justice is that an accident caused by negligence, for example, upsets an initial moral equilibrium by making a person worse off in some way. By paying compensation, however, the condition of the victim can be returned to what it was before the accident, thereby restoring the moral equilibrium. Similarly, a person who commits a crime upsets a moral equilibrium by making someone else worse off. The restoration of the moral equilibrium in cases of this kind is achieved by a punishment that "fits the crime." Both compensatory justice and retributive justice are *noncomparative*. The amount of compensation owed to the victim of an accident or the punishment due to a criminal is determined by the features of each case and not by a comparison with other cases.

A useful distinction not discussed by Aristotle is that between just *procedures* and just *outcomes*.<sup>28</sup> In cases of distributive justice, we can distinguish between the procedures used to distribute goods and the outcome of those procedures, that is, the actual distribution achieved. A similar distinction can be made between the procedures for conducting trials, for example, and the outcomes of trials. If we know what outcomes are just in certain kinds of situations, then just procedures are those that produce or are likely to produce just outcomes. Thus, an effective method for dividing a cake among a group consists of allowing one person to cut it into the appropriate number of slices with the stipulation that that person take the last piece. Assuming that an equal division of the cake is just, a just distribution will be achieved, because cutting the cake into equal slices is the only way the person with the knife is assured of getting at least as much cake as anyone else. Similarly, just outcomes in criminal trials are those in which the guilty are convicted and the innocent are set free. The complex rules and procedures for trials are those that generally serve to produce those results.

### 3.5.2: Aristotle on Distributive Justice

Aristotle described justice as a kind of equality, but this is not very helpful since equality is subject to varying interpretations.<sup>29</sup> The extreme egalitarian position that everyone

should be treated exactly alike has found few advocates, and most who call themselves egalitarians are concerned only to deny that certain differences ought to be taken into account. A more moderate egalitarianism contends that we ought to treat like cases alike. That is, any difference in the treatment of like cases requires a moral justification.

Aristotle expressed the idea of treating like cases alike in an arithmetical equation that represents justice as an equality of ratios.<sup>30</sup> Let us suppose that two people, A and B, each receive some share of a good, P. Any difference in their relative shares must be justified by some relevant difference, Q. Thus, a difference in pay, P, is justified if there is a difference in some other factor, Q, that justifies the difference in P—such as the fact that one person worked more hours or was more productive. Aristotle added the further condition that the difference in each person's share of the good must be *proportional* to the difference in his or her share of the relevant difference. If one person worked twice as many hours as another, and the amount of time worked is the only relevant factor, then the pay should be exactly twice as much—no more and no less. Aristotle's principle of distributive justice can be stated in the following manner.<sup>31</sup>

$$\frac{A's \text{ share of } P}{B's \text{ share of } P} = \frac{A's \text{ share of } Q}{B's \text{ share of } Q}$$

This account of Aristotle's principle of distributive justice is obviously not complete until the contents of both P and Q are fully specified. What are the goods in question? What features justify different shares of these goods? Among the goods distributed in any society are material goods, such as food, clothing, housing, income, and wealth, which enable people to purchase material goods. There are many nonmaterial goods, including economic power, participation in the political process, and access to the courts, which are also distributed in some manner. Finally, Aristotle counted honor as a good, thereby recognizing that society distributes status and other intangibles.

Among the many different justifying features that have been proposed are ability, effort, accomplishment, contribution, and need.<sup>32</sup>

#### Example: Possible Justifications for Unequal Pay

In setting wages, for example, an employer might award higher pay to workers who:

- have greater training and experience or greater talent (ability);
- apply themselves more diligently, perhaps overcoming obstacles or making great sacrifices (effort);
- have produced more or performed notable feats (accomplishment) or who provide more valued services (contribution); or,
- have large families to support or who, for other reasons, have greater need.

## WRITING PROMPT

### The Concept of Distributive Justice

A manager is passed over for a lucrative promotion because her team regularly fails to meet project deadlines and goes over budget. The promotion is given instead to a manager who has been with the company for a shorter period of time, but whose team makes their deadlines and manages to stay within budget. Develop a case that explains why this promotion is fair. Develop a case that explains why it is not.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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### 3.5.3: Rawls's Egalitarian Theory

In *A Theory of Justice* (1971), the contemporary American philosopher John Rawls (1921–2002) offered two principles that he thought express our considered views about justice. Rawls began by asking us to imagine a situation in which rational, free, and equal persons, concerned to advance their own interests, attempt to arrive at unanimous agreement on principles that will serve as the basis for constructing the major institutions of society. Rawls stipulated further that these individuals are asked to agree on the principles of justice behind a *veil of ignorance*, which prevents them from knowing many facts about themselves and their situation. Behind this veil, the bargainers are forced to be impartial and to view proposed principles from the perspective of all persons at once. Without any knowledge of their race or sex, for example, they are unlikely to advocate or support discriminatory principles because they could be among the victims of discrimination.

Now, what principles would rational, self-interested persons freely agree to in a position of equality behind a veil of ignorance? Rawls proposed two principles, which he stated as follows:

1. **Each person is to have an equal right to the most extensive total system of basic liberties compatible with a similar system of liberty for all.**

**Rationale:** The reasoning behind the first principle is that rational individuals under a veil of ignorance will choose an equal share of basic liberties (such as freedom of expression, association and political participation) because these liberties are essential to everyone, no matter their position in life.

2. **Social and economic inequalities are to be arranged so that they are both,**
  - a. **to the greatest benefit of the least advantaged, and**
  - b. **attached to offices and positions open to all under conditions of fair equality of opportunity.**<sup>33</sup>

**Rationale:** The second principle recognizes that there are two conditions under which rational, self-interested persons would make an exception to the first principle and accept less than an equal share of some goods.

Like the person who cuts the cake knowing that he will get the last piece, persons in the original position would generally opt for equal shares. However, according to **principle 2a**, called the *difference principle*, an unequal distribution is justified if everyone would be better off with the inequality than without it. If it is possible to increase the total amount of income, for example, but not possible to distribute it equally, then the resulting distribution is still just, according to Rawls, as long as the extra income is distributed in such a way that everyone benefits from the inequality.

**Principle 2b**, the *principle of equal opportunity*, is similar to the view that careers should be open to all on the basis of talent. Whether a person gets a certain job, for example, ought to be determined by competence in that line of work and not by skin color, family connections, or any other irrelevant characteristic.

### 3.5.4: Nozick's Entitlement Theory

Robert Nozick (1938–2002) offered a theory of justice, called the entitlement theory, which stands alongside Rawls's egalitarianism as a major contemporary account of justice. The principles of justice in Nozick's theory differ from Rawls's theory in two major respects.

1. First, they are *historical* principles as opposed to *non-historical* or *end-state* principles.<sup>34</sup> Historical principles, Nozick explains, take into account the process by which a distribution came about, whereas end-state principles evaluate a distribution with regard to certain structural features at a given time.
2. Second, the principles of justice in both Aristotle's and Rawls's theories are *patterned*.<sup>35</sup> A principle is patterned if it specifies some feature in a particular distribution and evaluates the distribution according to the presence or absence of that feature. Any principle of the form "Distribute according to \_\_\_\_\_," such as "Distribute according to IQ scores," is a patterned principle, as is the socialist formula, "From each according to his abilities, to each according to his needs."

Nozick thought that any acceptable principle of justice must be nonpatterned because any particular pattern of distribution can be achieved and maintained only by violating the right to liberty. Upholding the right to liberty, in turn, upsets any particular pattern of justice. He argued for this point by asking us to consider a case in which there is a perfectly just distribution, as judged by some desired pattern, and also perfect freedom.

**Example:** Suppose that a famous athlete—Nozick suggested Wilt Chamberlain—will play only if he is paid an additional 25 cents for each ticket sold and that many people are so excited to see Wilt Chamberlain play that they will cheerfully pay the extra 25 cents for the privilege.



### What distribution of income will result from this arrangement?

Both Wilt Chamberlain and the fans are within their rights to act as they do; but at the end of the season, if 1 million people pay to see him play, then Wilt Chamberlain will have an additional income of \$250,000, which is presumably more than he would be entitled to on a patterned principle of justice (such as a performance-based salary or a fair percentage of regular ticket sales). By exercising their right to liberty, though, Wilt Chamberlain and the fans have upset the just distribution that formerly prevailed.

### Could the resulting distribution be altered in a just manner?

In order to maintain the patterned distribution, it would be necessary to restrict the freedom of Wilt Chamberlain or the fans in some way, such as prohibiting the extra payment or taxing away the excess. However, such a restriction of freedom might itself be considered unjust.

The entitlement theory can be stated very simply.

A distribution is just, Nozick said, “if everyone is entitled to the holdings they possess.”<sup>36</sup>

Whether we are entitled to certain holdings is determined by tracing their history. Most of what we possess comes from others through transfers, such as purchases and gifts. Thus, we might own a piece of land because we bought it from someone, who in turn bought it from someone else, and so on. Proceeding backward in this fashion, we ultimately reach the original settler who did not acquire it through a transfer but by clearing the land and tilling it. As long as each transfer was just and the original acquisition was just, our present holding is just. “Whatever arises from a just situation by just steps is itself just,” Nozick wrote.<sup>37</sup> In his theory, then, particular distributions are just not because they conform to some pattern (equality or social utility, for example) but solely because of antecedent events.

Nozick’s theory thus requires at least two principles: a **principle of just transfer** and a **principle of just original**

**acquisition**. Because holdings can be unjustly appropriated by force or fraud, a third principle, a **principle of rectification**, is also necessary in order to correct injustices by restoring holdings to the rightful owners. If we rightfully possess some holding—a piece of land, for example, by either transfer or original acquisition—then we are free to use or dispose of it as we wish. We have a right, in other words, to sell it to whomever we please at whatever price that person is willing to pay, or we can choose to give it away. As long as the exchange is purely voluntary, with no force or fraud, the resulting redistribution is just. Any attempt to prevent people from engaging in voluntary exchanges in order to secure a particular distribution is a violation of liberty, according to the entitlement theory.

A world consisting only of just acquisitions and just transfers would be just, according to Nozick, no matter what pattern of distribution results. Some people, through hard work, shrewd trades, or plain good luck, would most likely amass great wealth, whereas others, through indolence, misjudgment, or bad luck, would probably end up in poverty. However, the rich in such a world would have no obligation to aid the poor,<sup>38</sup> nor would it be just to coerce them into doing so. Each person’s share would be determined largely through his or her choices and those of others. Nozick suggested that the entitlement theory can be expressed simply as “From each as they choose, to each as they are chosen.”

The entitlement theory supports a market system with only the absolute minimum of government intervention, as long as the principles of just acquisition and just transfer are satisfied. The reason is that a system in which we have complete freedom to acquire property and engage in mutually advantageous trades (without violating the rights of another person, of course) is one in which our own rights are most fully protected. To critics who fear that unregulated markets would lead to great disparities between the rich and the poor and a lowering of the overall welfare of society, Nozick had a reply. The point of justice is not to promote human well-being or to achieve a state of equality; it is to protect our rights. Because a market system does this better than any other form of economic organization, it is just.

## Conclusion: Ethical Theories

This chapter presents the main concepts and theories of ethics that have been developed over centuries by major moral philosophers. The value of any theory for business ethics is its usefulness in evaluating business practices, institutional arrangements, and economic systems. In general, all of these theories justify most prevailing

business practices, the institution of the modern corporation, and capitalism or the market system, but they also provide the basis for some criticism and improvement. In the subsequent chapters, this theoretical foundation is used to explore a wide range of practical business ethics topics.

## End-of-Chapter Case Studies

This chapter concludes with four case studies.

These cases illustrate long-recognized tensions between the major ethical theories. The memo in “Exporting Pollution” employs seemingly valid utilitarian reasoning in the form of cost–benefit analysis, but the conclusions may strike some readers as ethically unacceptable. The classic “dirty hands” problem, which dates back to Machiavelli (i.e., Should a great leader be willing to commit immoral acts in achieving great ends?) is displayed in “Clean Hands in a Dirty Business,” as one friend attempts to persuade another that what appears to be unethical conduct (Kant) might have overall beneficial consequences (Bentham and Mill). “Conflict of an Insurance Broker” shows that it is not always clear what it means for an agent to act in the interest of the client, especially when agency duties are complicated, as they are in this case, by conflict of interest. Important lessons in “An Auditor’s Dilemma” are that the utilitarian search for consequences must probe deeply to find less obvious harms and that the Kantian question (What would happen if everyone acted in the same way?) can be usefully combined with utilitarianism to produce a more complete analysis.

### Case: Exporting Pollution

As an assistant to the vice president of environmental affairs at Americhem, Rebecca Wright relished the opportunity to apply her training in public policy analysis to the complex and emotion-laden issues that her company faces.<sup>39</sup> Rebecca was convinced that cost–benefit analysis, her specialty, provides a rational decision-making tool that cuts through personal feelings and lays bare the hard economic realities. Still, she was startled by the draft of a memo that her boss, Jim Donnelly, shared with her. The logic of Jim’s argument seemed impeccable, but the conclusions were troubling—and Rebecca was sure that the document would create a furor if it were ever made public.

Jim was preparing the memo for an upcoming decision on the location for a new chemical plant. The main problem was that atmospheric pollutants from the plant, although mostly harmless, would produce a persistent haze, and one of the particles that would be released into the atmosphere is also known to cause liver cancer in a very small portion of the people exposed. Sitting down at her desk to write a response, Rebecca read again the section of the memo that she had circled with her pen.

From an environmental point of view, the case for locating the new plant in a Third World country is overwhelming. These reasons are especially compelling in my estimation:

1. The harm of pollution, and hence its cost, increases in proportion to the amount of already existing

pollution. Adding pollutants to a highly polluted environment does more harm than the same amount added to a relatively unpolluted environment. For this reason, much of the Third World is not efficiently utilized as a depository of industrial wastes, and only the high cost of transporting wastes prevents a more efficient utilization of this resource.

2. The cost of health-impairing pollution is a function of the forgone earnings of those who are disabled or who die as a result. The cost of pollution will be least, therefore, in the country with the lowest wages. Any transfer of pollution from a high-wage, First World country to a low-wage, Third World country will produce a net benefit.
3. The risk of liver cancer from this plant’s emissions has been estimated at one-in-a-million in the United States, and the resulting cancer deaths would occur mostly among the elderly. The risk posed by the new plant will obviously be much less in a country where people die young from other causes and where few will live long enough to incur liver cancer from any source. Overall, the people of any Third World country might prefer the jobs that our plant will provide if the only drawback is a form of cancer that they are very unlikely to incur.
4. The cost of visibility-impairing pollution will be greater in a country where people are willing to spend more for good visibility. The demand for clear skies—which affects the aesthetics of the environment and not people’s health—has very high-income elasticity, and so the wealthy will pay more than the poor to live away from factory smoke, for example. Because the cost of anything is determined by how much people are willing to pay in a market, the cost of visibility-impairing pollution in a First World country will be higher than the same amount of pollution in a Third World country. Thus, people in the United States might prefer clear skies over the benefits of our plant, but people elsewhere might choose differently.

#### SHARED WRITING: EXPORTING POLLUTION

This case is based on an actual memo that aroused a storm of criticism. What points in the memo might critics consider to be morally objectionable? Should moral criticism be directed only to this particular application of cost–benefit analysis or to the method of cost–benefit itself?

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

### Case: Clean Hands in a Dirty Business

Even with her newly-minted MBA degree, Janet Moore was having no luck finding that dream job in the marketing department of a spirited, on-the-move company. Now,

almost any job looked attractive, but so far no one had called her back for a second interview. Employers were all looking for people with experience, but that requires getting a job first. Just as she began to lose hope, Janet bumped into Karen, who had been two years ahead of her in college. Karen, too, was looking for a job, but in the meantime she was employed by a firm that was planning to add another marketing specialist. Janet was familiar with Karen's employer from a case study that she had researched for an MBA marketing course, but what she had learned appalled her.

The company, Union Tobacco, Inc., is the major U.S. manufacturer of snuff, and her case study examined how this once staid company had managed to attract new customers to a product that had long ago saturated its traditional market.<sup>40</sup> Before 1970, almost all users of snuff—a form of tobacco that is sucked rather than chewed—were older men. The usual form of snuff is unattractive to non-users because of the rough tobacco taste, the unpleasant feel of loose tobacco particles in the mouth, and the high nicotine content, which makes many first-time users ill. Snuff, to put it mildly, is a hard sell.

The company devised a product development and marketing campaign that a federal government report labeled a "graduation strategy." Two new lines were developed—a low-nicotine snuff in a tea-bag-like pouch with a mint flavor that had proved to be popular with young boys and a step-up product with slightly more nicotine, a cherry flavor, and a coarse cut that avoids the unpleasantness of tobacco floating in the mouth. Both products are advertised heavily in youth-oriented magazines with the slogan "Easy to use, anywhere, anytime," and free samples are liberally distributed at fairs, rodeos, and car races around the country.

The strategy had worked to perfection. Youngsters who started on the low-nicotine mint- and cherry-flavored products soon graduated to the company's two stronger, best-selling brands. Within two decades, the market for snuff tripled to about 7 million users, of which 1 million to 2 million are between the ages of 12 and 17. The average age of first use was now estimated to be 9½ years old. Janet also reported in her case study that snuff users were more than 4 times more likely to develop cancers of the mouth generally and 50 times more likely to develop specific cancers of the gum and inner-cheek lining. Several suits had been filed by the parents of teenagers who had developed mouth cancers, and tooth loss and gum lesions have also been widely reported, even in relatively new users.

Karen admitted that she was aware of all this but encouraged Janet to join her anyway. "You wouldn't believe some of the truly awful marketing ploys that I have been able to scuttle," she said. "Unless people like you and me get involved, these products will be marketed by people who don't care one bit about the little kids who are getting hooked on snuff. Believe me, it's disgusting work. I don't like to tell people what I do, and I sometimes look at

myself in the mirror and ask what has become of the idealism I had starting out. But there will always be someone to do this job, and I feel that I have made a difference. If you join me, the two of us together can slow things down and avoid the worst excesses, and maybe we'll even save a few lives. Plus, you can get some experience and be in a better position to move on."

Janet admitted to herself that Karen had a strong argument. Maybe she was being too squeamish and self-centered, just trying to keep her own hands clean. Maybe she could do others some good and help herself at the same time by taking the job. But then again. . . .

### SHARED WRITING: CLEAN HANDS IN A DIRTY BUSINESS

On what grounds can Karen's work at the tobacco company be considered ethical or unethical? Explain whether or not you believe that Karen has made a morally significant difference and done more good than harm, as she states. Would you advise Janet to take the job or hold out for something else?

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Conflict of an Insurance Broker

I work for an insurance brokerage firm, Ashton & Ashton (A&A), which is hired by clients to obtain the best insurance coverage for their needs.<sup>41</sup> To do this, we evaluate a client's situation, keep informed about insurance providers, negotiate on the client's behalf, and present a proposal to the client for approval. Our compensation comes primarily from a commission that is paid by the client as part of the premium. The commission is a percentage of the premium amount, and the industry average for commissions is between 10 percent and 15 percent. A secondary source of compensation is a contingency payment that is made annually by insurance providers; the amount of this payment is based on the volume of business during the past year.

One of our clients, a world-class museum in a major American city, has been served for years by Haverford Insurance Company. Haverford is a financially sound insurer that has provided the museum with reliable coverage at reasonable prices and has gone out of its way on many occasions to be accommodating. Haverford has also built good relations with A&A by allowing a 17 percent commission—a fact that is not generally known by the clients. When the museum's liability insurance policy

came up for renewal, A&A was asked to obtain competitive proposals from likely insurers. We obtained quotations from four comparable insurance companies with annual premiums that ranged between \$90,000 and \$110,000. A fifth, unsolicited proposal was sent by a small, financially shaky insurance company named Reliable. The annual premium quoted by Reliable was \$60,000.

There is no question that the museum is best served by continuing with Haverford, and our responsibility as an insurance broker is to place clients with financially sound insurers that will be able to honor all claims. The museum has a very tight operating budget, however, and funding from public and private sources is always unpredictable. As a result, the museum is forced to be extremely frugal in its spending and has always chosen the lowest bid for any service without regard for quality. The dilemma I faced, then, was: Should I present the Reliable bid to the museum? If I present Reliable's bid, the museum will almost certainly accept it given its priority of saving money. Because the market indicates that the value of the needed policy is around \$100,000, the Reliable proposal is definitely an attempt to "low-ball" the competition, and the company would probably raise the premium in future years. Is this honest competition? And if not, should A&A go along with it? Allowing a client to accept a low-ball bid might also jeopardize our relations with the reputable insurers that submitted honest proposals in good faith. If relations with Reliable are not successful, the museum is apt to blame us for not doing our job, which is not merely to pass along proposals but to evaluate them for suitability.

On the other hand, A&A will receive a higher commission and a larger contingency payment at the end of the year if the museum is presented with only the four solicited proposals and never learns of the Reliable bid. Because of our financial stake in the outcome, however, do we face a conflict of interest? Could we be accused of choosing a course of action that benefits us, even though in reality the client is also better served?

#### SHARED WRITING: CONFLICT OF AN INSURANCE BROKER

Explain whether or not A&A would be acting responsibly in its role as a broker by allowing the museum to make a poor choice. How can the broker act responsibly toward the museum while still presenting the inferior insurance bid?

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: An Auditor's Dilemma

Sorting through a stack of invoices, Alison Lloyd's attention was drawn to one from Ace Glass Company. Her responsibility as the new internal auditor for Gem Packing was to verify all expenditures, and she knew that Ace had already been paid for the June delivery of the jars that are used for Gem's jams and jellies. On closer inspection, she noticed that the invoice was for deliveries in July and August that had not yet been made. Today was only June 10. Alison recalled approving several other invoices lately that seemed to be misdated, but the amounts were small compared with \$130,000 that Gem spends each month for glass jars. "I had better check this out with purchasing," she thought.

Over lunch, Greg Berg, the head of purchasing, explained the system to her. The jam and jelly division operates under an incentive plan whereby the division manager and the heads of the four main units—sales, production, distribution, and purchasing—receive substantial bonuses for meeting their quota in pretax profits for the fiscal year, which ends on June 30. The bonuses are about one-half of annual salary and constitute one-third of the managers' total compensation. In addition, meeting quota is weighted heavily in evaluations, and missing even once is considered to be a deathblow to the career of an aspiring executive at Gem. So the pressure on these managers is intense. On the other hand, there is nothing to be gained from exceeding a quota. An exceptionally good year is likely to be rewarded with an even higher quota the next year because quotas are generally set at corporate headquarters by adding 5 percent to the previous year's results.

Greg continued to explain that several years ago, after the quota had been safely met, the jam and jelly division began prepaying as many expenses as possible—not only for glass jars but also for advertising costs, trucking charges, and some commodities such as sugar. The practice has continued to grow, and sales also helps out by delaying orders until the next fiscal year or by falsifying delivery dates when a shipment has already gone out. "Regular suppliers like Ace Glass know how we work," Greg said, "and they sent the invoices for July and August at my request." He predicted that Alison will begin seeing more irregular invoices as the fiscal year winds down. "Making quota gets easier each year," Greg observed, "because the division gets an ever-increasing head start, but the problem of finding ways to avoid going too far over quota has become a real nightmare." Greg is not sure, but he thinks that other divisions are doing the same thing. "I don't think corporate has caught on yet," he said, "but they created the system, and they've been happy with the results so far. If they're too dumb to figure out how we're achieving them, that's their problem."

Alison recalled that upon becoming a member of the Institute of Internal Auditors (IIA), she agreed to abide by the IIA code of ethics. This code requires members to exercise “honesty, objectivity, and diligence” in the performance of their duties but also to be loyal to the employer. However, loyalty does not include being a party to any “illegal or improper activity.” As an internal auditor, she is also responsible for evaluating the adequacy and effectiveness of the company’s system of financial control. “But what is the harm of shuffling a little paper around? Nobody is getting hurt, and it all works out in the end,” she thinks to herself.

### SHARED WRITING: AN AUDITOR’S DILEMMA

What, if anything, is really wrong with the practice that Greg has explained? How could someone criticize Alison’s assessment that “nobody is getting hurt, and it all works out in the end”?



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

### Chapter 3 Quiz: Ethical Theories

# Chapter 4

# Whistle-Blowing



## Learning Objectives

- 4.1 Define the significance of whistle-blowing and the act itself according to seven criteria
- 4.2 Assess situations where whistle-blowing may or may not be justified, given the duties and obligations of all parties and the potential consequences of the act
- 4.3 Describe the characteristics and importance of laws designed to protect whistle-blowers and key points in the debate over the moral justification of these laws
- 4.4 Identify the importance of developing an effective whistle-blowing policy for an organization and the key components of such a policy

### Case: *Time's* Persons of the Year

In a year of momentous events, *Time* magazine honored three whistle-blowers as “persons of the year” for 2002.<sup>1</sup> With the collapse of Enron and WorldCom and the aftermath of 9/11 still reverberating, this annual cover story brought recognition to three women who played important roles in these calamities.

*Sherron Watkins* wrote a lengthy memo to Ken Lay, her top boss at Enron, warning of the financial time bomb hidden in the company’s questionable off-balance-sheet partnerships.<sup>2</sup> “I am incredibly nervous,” she wrote, “that we will implode in a wave of accounting scandals.”

*Cynthia Cooper*, the head of internal auditing at WorldCom, unraveled the accounting irregularities that enabled CEO Bernie Ebbers and CFO Scott Sullivan to hide almost \$4 billion in losses (a figure that eventually totaled more than \$9 billion).<sup>3</sup>

And *Coleen Rowley*, a career FBI agent in Minneapolis, sent a confidential 13-page memo to the agency’s director, Robert Mueller, contradicting his claim that there was no evidence that terrorists were planning the 9/11 attacks.<sup>4</sup> She complained that the head office in Washington, DC, had ignored pleas from the Minneapolis branch to investigate Zacarias Moussaoui, the alleged missing twentieth hijacker, who had been eager to learn how to fly a Boeing 747, and had also overlooked reports from an agent in Phoenix about Middle-Eastern students seeking to enroll in flying schools there.

### Similarities and Differences

In each case, these “persons of the year,” all women who occupied relatively high positions, had exhibited extraordinary courage and determination to establish the truth and make it known to those in charge. None of them sought public acclaim or even thought of themselves as whistle-blowers. They submitted their memos confidentially to the appropriate parties. Watkins responded to an open invitation by Lay, the chairman of the board, for Enron employees to air their concerns after the sudden departure of CEO Jeffrey Skilling. She explained to Lay that Skilling probably saw the coming collapse and wanted to avoid involvement. Cooper reported her findings to the audit committee of WorldCom’s board because Ebbers and Sullivan, her superiors, were deeply implicated. Only Rowley went outside the usual chain of command by writing directly to the FBI director. Their memos became public when they were leaked during preparations for congressional hearings. Watkins and Rowley were eventually called to testify before Congress, but Cooper was excused to avoid interfering with a Justice Department investigation of WorldCom.

Their motivation, in each case, was to save the organization and, for Watkins and Rowley, the top leaders from serious mistakes. Watkins apparently thought that Lay was unaware of the danger facing the company and that, once informed, he would take corrective action. (She would discover later that Lay’s immediate response was to seek an opinion from a company lawyer on whether she could be terminated.) Rowley sought to apprise FBI director Mueller of the truth so that he could correct his public statements and avoid the political damage that might result from any revelations about the

bungled Moussaoui investigation. She also urged Mueller to undertake reforms that she thought would strengthen the agency. Only Cooper seemed to be aware that her revelations could cause great problems for her superiors, Ebbers and Sullivan, in this case, but she recognized that the board of directors rightly controls the corporation and has ultimate responsibility for protecting it. She no doubt thought that the audit committee of the board, which has the task of ensuring proper accounting, would take appropriate action, as indeed it did.

A further similarity is that each whistle-blower did not voice vague, unfounded concerns but assembled a carefully documented list of possible wrongdoings. The charges in their memos were made more credible by the women's expertise and insider's knowledge. Watkins obtained a master's degree in accounting and had risen in the ranks at Arthur Andersen, where she worked on the Enron account before being recruited by the company in 1993. At Enron, she held four high-level finance positions in seven years, eventually becoming vice president of corporate development. In her memo, she explained in detail the problems with two off-the-books partnerships, the Condor and the Raptor deals, and urged that they be reviewed by independent law and accounting firms. Cooper and her staff worked many weeks, often after hours, untangling WorldCom's irregular accounting practices, and in a meeting with the audit committee in Washington, DC, she was able to explain how CFO Sullivan and the company's controller had systematically recorded expenses as capital investments, a clear violation of accounting rules. In keeping with Rowley's sole purpose "to provide the facts within my purview so that an accurate assessment can be obtained," she provided an exhaustive account with footnotes of the Minneapolis agents' investigation of Moussaoui and the obstacles thrown up by the Washington head office.<sup>5</sup>

Much has been made of the fact that all three of these whistle-blowers are women, a feature they share with two other prominent whistle-blowers whose stories were made into popular movies, namely, Karen Silkwood and Erin Brockovich.<sup>6</sup> However, research suggests that women are less likely than men to blow the whistle.<sup>7</sup> Several other common factors, though, may explain why these women became whistle-blowers. They had benefited from the breaks in the glass ceiling that allowed them to assume high positions, which in turn enabled them to witness wrongdoing and to have credibility reporting it. At the same time, they were still outsiders in a clubby male culture and did not share the values of their male colleagues or their sense of belonging. Anita Hill, who herself gained national attention by raising charges of sexual harassment in the confirmation process for Supreme Court justice Clarence Thomas, calls these women "insiders with outsider values."<sup>8</sup> Hill suggests that women's sensitivity to their own mistreatment in the workplace may

make them more sensitive to other kinds of wrongdoing and more willing to speak out against them. As one journalist observed, these whistle-blowers prove that "there are women talented enough to break through the glass ceiling who are even more willing to break more glass to make the climb to the top worth it."<sup>9</sup>

### Were they really whistle-blowers?

#### Compare Your Thoughts

Questions have also been raised about whether these women were even whistle-blowers. Although each wrote an explosive memo, it was sent confidentially to a person at the top of the organization with the aim of protecting the organization. No one went outside the chain of command. Only Coleen Rowley's memo to the audit committee of the board produced decisive, corrective action. After Watkins met personally with Lay, he turned the memo over to the same law firm that had approved many Enron transactions, and, unsurprisingly, this firm found no substance to the charges she raised. The memos by Watkins and Rowley provided top leaders with an opportunity to protect themselves before any bad news reached the public. And all three memos came to light only because of congressional hearings.

Watkins's action, in particular, has been criticized. Her memo advises Lay to develop a "clean up plan" that consists in the best case to clean up "quietly if possible," and in the worst case to develop public relations, investor relations, and customer assurance plans, legal actions, dismissals, and disclosure. By assuming that Lay was uninformed about Enron's financial problems, some charge that Watkins bolstered his legal defense strategy of ignorance. One expert on whistle-blowing said, "She spoke up, but I don't see any evidence that she resisted or went beyond in some way to demand a remedy."<sup>10</sup> Dan Ackman of *Forbes* magazine was more critical:

A whistle-blower, literally speaking, is someone who spots a criminal robbing a bank and blows the whistle alerting police. That's not Sherron Watkins. What the Enron vice president did was write a memo to the bank robber, suggesting he stop robbing the bank and offering ways to avoid getting caught. Then she met with the robber, who said he didn't believe he was robbing the bank, but said he'd investigate to find out for sure. Then, for all we know, Watkins did nothing, and her memo was not made public until congressional investigators released it six weeks after Enron filed for bankruptcy.<sup>11</sup>

Whether Watkins, Cooper, and Rowley are whistle-blowers in a precise sense, most people would probably agree with *Time* magazine that "They were people who did right just by doing their jobs rightly—which means ferociously, with eyes wide open and with the bravery the rest of us always hope we have and may never know if we do."

## Points to Consider...

There have always been informers, or snitches, who reveal information to enrich themselves or to get back at others. However, whistle-blowers like *Time* magazine's "persons of the year" are generally conscientious people who expose some wrongdoing, often at great personal risk. The term "whistle-blower" was first applied to government employees who "go public" with complaints of corruption or mismanagement in federal agencies.<sup>12</sup> It is also now used in connection with similar activities in the private sector, as well as with the conduct of government contractors. Opinion differs, for example, on whether Edward Snowden, an employee of a contractor, was a whistle-blower when he released classified documents exposing domestic surveillance by the National Security Agency.<sup>13</sup>

Whistle-blowers often pay a high price for their acts of dissent.

Watkins, Cooper, and Rowley emerged from their experience relatively unscathed, but most whistle-blowers are not so fortunate. *Retaliation* is common and can take many forms—from poor evaluations and demotion to outright dismissal. Some employers seek to blacklist whistle-blowers so that they cannot obtain jobs in the same industry. Many whistle-blowers suffer career disruption and financial hardship resulting from the job dislocation and legal expenses, and there is severe emotional strain on them and their families as coworkers, friends, and neighbors turn against them.

Given the high price that whistle-blowers sometimes pay, should people really be encouraged to blow the whistle? Is the exposure of corruption and mismanagement in government and industry the best way to correct these faults? Or are there more effective ways to deal with them without requiring individuals to make heroic personal sacrifices? Should whistle-blowers be protected, and if so, how can this best be done?

In addition to these practical questions, there are more philosophical issues about the ethical justification of whistle-blowing.

Do employees have a right to blow the whistle?

Although they usually act with the laudable aim of protecting the public by drawing attention to wrongdoing on the part of their organization, whistle-blowers also run the risk of violating genuine obligations that employees owe to employers. Employees have an obligation to do the work that they are assigned, to be loyal to their employer, and generally to work for the interest of the company, not against it. In addition, employees have an obligation to preserve the confidentiality of information acquired in the course of their work, and whistle-blowing sometimes involves the release of this kind of information. Cases of

whistle-blowing are so wrenching precisely because they involve very strong conflicting obligations. It is vitally important, therefore, to understand when it is morally permissible to blow the whistle and when whistle-blowing is, perhaps, not justified. Our first task, though, is to develop a definition of whistle-blowing.

### WRITING PROMPT

#### Examining Personal Biases

When you hear about whistle-blowers in the news, what is your first reaction? Are whistleblowers typically telling the truth, or are you skeptical of their motives? Explain your opinion.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 4.1: What Is Whistle-Blowing?

### 4.1 Define the significance of whistle-blowing and the act itself according to seven criteria

As a first approximation, whistle-blowing can be defined as the release of information by a member or former member of an organization that is evidence of illegal and/or immoral conduct in the organization or conduct in the organization that is not in the public interest. There are several points to observe in this definition.

**First, blowing the whistle is something that can be done only by a member of an organization.** It is not whistle-blowing when a witness to a crime notifies the police and testifies in court. It is also not whistle-blowing for a reporter who uncovers some illegal practice in a corporation to expose it in print. Both the witness and the reporter have incriminating information, but they are under no obligation that prevents them from making it public. The situation is different for employees who become aware of illegal or immoral conduct in their own organization because they have an obligation to their employer that would be violated by public disclosure. Whistle-blowing, therefore, is an action by an individual *inside* an organization to expose wrongdoing to those *outside* it.

**Second, there must be information.** Merely to dissent publicly with an employer is not in itself blowing the whistle; whistle-blowing necessarily involves the release of *nonpublic information*. According to Sissela Bok, "The whistleblower assumes that his message will alert listeners to something they do not know, or whose significance they have not grasped because it has been kept secret."<sup>14</sup> A distinction can be made between *blowing the whistle* and *sounding the alarm*. Instead of revealing new facts, as



whistle-blowers do, dissenters who take a public stand in opposition to an organization to which they belong can be viewed as trying to arouse public concern, to get people alarmed about facts that are already known rather than to tell them something they do not know.

**Third, the information is generally evidence of some significant kind of misconduct on the part of an organization or some of its members.** The term “whistle-blowing” is usually reserved for matters of substantial importance. Certainly, information about the lack of preparedness by the FBI to protect American citizens against terrorist acts like those on 9/11 would justify the memo that Coleen Rowley sent to the director of her agency. Some whistle-blowing reveals violations of law, such as the accounting fraud at WorldCom that Cynthia Cooper uncovered, but an employee could also be said to blow the whistle about activities that are legal but contrary to the public interest, such as waste and mismanagement in government procurement or threats to the environment. Information of this kind could alert the public and possibly lead to new legislation or regulation. However, merely exposing incompetent or self-serving management or leaking information to influence the course of events is not commonly counted as whistle-blowing. Lacking in these kinds of cases is a serious wrong that could be averted or rectified by whistle-blowing.

**Fourth, the information must be released outside normal channels of communication.** In most organizations, employees are instructed to report instances of illegal or improper conduct to their immediate superiors, and other means often exist for employees to register their concerns. Some corporations have an announced policy of encouraging employees to submit any suspicions of misconduct in writing to the CEO, with an assurance of confidentiality. Others have a designated official, often called an *ombudsman*, for handling employee complaints. Whistle-blowing does not necessarily involve “going public” and revealing information outside the organization. There can be *internal* as well as *external* whistle-blowing. However, an employee who follows established procedures for reporting wrongdoing is not a whistle-blower. Thus, Watkins, Cooper, and Rowley are probably not whistle-blowers in a precise sense, despite the use of this label in the popular press.

**Fifth, a definition of whistle-blowing also needs to take into account to whom the whistle is blown.** In both internal and external whistle-blowing, the information must be revealed in ways that can reasonably be expected to bring about a desired change. Merely passing on information about wrongdoing to a higher-up or a third party does not necessarily constitute whistle-blowing. Going to the press is often effective because the information ultimately reaches the appropriate authorities. Reporting to a credit-rating agency that a person faces bankruptcy, by

contrast, would not usually be an instance of whistle-blowing but of ordinary snitching because the receiving party in this case is not an appropriate authority.

**Sixth, the release of information must be something that is done voluntarily, as opposed to being legally required.** The distinction, however, is not always clear. Watkins and Rowley were called to testify before congressional committees. Although such testimony may be legally required, the call to testify may come only after witnesses volunteer that they have incriminating evidence. However, in a state supreme court case, *Petermann v. International Brotherhood of Teamsters*, a treasurer for a union had no desire to be a whistle-blower, but he refused to perjure himself before a California state legislative body as he had been ordered to do by his employer.<sup>15</sup> Although Petermann acted with considerable courage, it is not clear whether he should be called a whistle-blower because he had little choice under the circumstances since his testimony was legally compelled.

**A seventh and final point is that whistle-blowing must be undertaken as a moral protest.** That is, the motive must be to correct some wrong and not to seek revenge or personal advancement. This is not to deny that a person with incriminating evidence could conceivably be justified in coming forth, whatever the motive. People “go public” for all sorts of reasons—a common one being fear of their own legal liability—and by doing so, they often benefit society. Still, it is useful to draw a line between the genuine whistle-blower and corporate malcontents and intriguers. Because the motives of whistle-blowers are often misperceived in the organization, employees considering the act must carefully examine their own motivation.

### **Putting all these points together, what is a more adequate definition of whistle-blowing?**

A better (but unfortunately long-winded) definition of whistle-blowing is as follows:

Whistle-blowing is the voluntary release of nonpublic information, as a moral protest, by a member or former member of an organization outside the normal channels of communication to an appropriate audience about illegal and/or immoral conduct in the organization or conduct in the organization that is opposed in some significant way to the public interest.

Whistle-blowing is a unique ethical concern in business because it concerns how, when, and under what circumstances an agent of an organization is morally permitted to reveal otherwise confidential information about his or her employer. Despite the term’s popular usage when describing all sorts of controversial acts to expose wrongdoing, the term “whistle-blowing” focuses attention on the challenge of how to best balance the responsibilities of loyalty to one’s organization with the public’s interest.<sup>16</sup>

**Table 4.1** What Constitutes Whistle-Blowing?

Read each question and identify the defining characteristics of whistle-blowing. Show the cells to check your answers.

Criteria	Whistle-Blowing	Not Whistle-Blowing
<b>Who can blow the whistle?</b>	An individual inside an organization exposes wrongdoing.	A witness to a crime or a reporter
<b>What kind of information is involved?</b>	Nonpublic information that reveals new facts	Facts that are already known to the public
<b>What is it reserved for?</b>	Calling attention to matters of substantial importance	Exposing matters of minor importance, such as incompetent management
<b>Who is informed and how?</b>	External: An employee “goes public” to inform individuals or groups outside the organization. Internal: An employee informs others within the organization by going outside normal channels of communication.	An employee follows established procedures to report wrongdoing through normal channels of communication.
<b>What is the immediate goal?</b>	To correct a wrong by bringing about a desired change	To pass on information about wrongdoing to a supervisor, director, or a third party
<b>Was the person compelled to act?</b>	The release of information is voluntary.	The testimony is legally compelled (by a court of law).
<b>What is the motive?</b>	To stage a moral protest.	To seek revenge or personal advancement

Use Table 4.1 above to review the main considerations for determining whether an act truly constitutes whistle-blowing, as just defined.

## 4.2: Justification of Whistle-Blowing

### 4.2 Assess situations where whistle-blowing may or may not be justified, given the duties and obligations of all parties and the potential consequences of the act

The ethical justification of whistle-blowing might seem to be obvious in view of the laudable public service that whistle-blowers provide—often at great personal risk. However, whistle-blowing has the potential to do great harm to both individuals and organizations.

The negative case against whistle-blowing is given vigorous expression in a widely cited passage from a 1971 speech by James M. Roche, who was chairman of the board of General Motors Corporation at the time. He writes, “Some critics are now busy eroding another support of free enterprise—the loyalty of a management team, with its unifying values of cooperative work. . . . However this is labelled—industrial espionage, whistle blowing, or professional responsibility—it is another tactic for spreading disunity and creating conflict.”<sup>17</sup> In the same vein, Sissela Bok observes that “the whistleblower hopes to stop the game, but since he is neither referee or coach, and since he blows the whistle on his own team, his act is seen as a violation of loyalty.”<sup>18</sup>

As these remarks indicate, the main stumbling block in justifying whistle-blowing is the duty of loyalty that employees have to the organization of which they are a part. The public service that whistle-blowers provide has

to be weighed against the disruptive effect that the disclosure of information has on bonds of loyalty.

Does a person in a position to blow the whistle have a greater obligation to the public or to the organization? Where does the greater loyalty lie?

That we have an obligation to the public is relatively unproblematic; it is the obligation to prevent serious harm to others whenever this is within our power. An obligation of loyalty to an organization is more complex, involving, as it does, questions about the basis of such an obligation and the concept of loyalty itself. What does an employee owe an employer, and, more to the point, does the employment relation deprive an employee of a right to reveal information about wrongdoing in the organization? In order to answer these questions, let us begin with a commonly used argument against the right of an employee to blow the whistle.

#### WRITING PROMPT

##### Citizen or Employee?

How should a person in a position to blow the whistle determine whether he or she has a greater obligation to the public or to his or her employer? How should competing loyalties be balanced?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

### 4.2.1: Loyal Agent Argument

According to one argument, an employee is an *agent* of an employer.<sup>19</sup> An agent is a person who is engaged to act in the interests of another person (called a *principal*) and is authorized to act on that person’s behalf. This relationship is typical of professionals, such as lawyers and accountants, who are called upon to use their skills in the service of a

client. Employees are also considered to be agents of an employer in that they are hired to work for the benefit of the employer. Specifically, an employee, as an agent, has an obligation to work as directed, to protect confidential information, and, above all, to be loyal. All these are seemingly violated when an employee blows the whistle.

**DUTIES OF AN AGENT** The loyal agent argument receives considerable support from the law, where the concept of agency and the obligations of agents are well developed. Although our concern is with the *moral* status of employees, the law of agency is a rich source of relevant insights about the employment relation.<sup>20</sup> According to one standard book on the subject, “an agent is a person who is authorized to act for a principal and has agreed so to act, and who has power to affect the legal relations of his principal with a third party.”<sup>21</sup> Agents are employed to carry out tasks that principals are not willing or able to carry out for themselves. Thus, we hire a lawyer to represent us in legal matters where we lack the expertise to do the job properly.

The main obligation of an agent is to act in the interest of the principal. We expect a lawyer, for example, to act as we would ourselves, if we had the same ability. This obligation is expressed in the *Second Restatement of Agency* as follows: “[A]n agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.”<sup>22</sup> The ethical basis of the duty of agents is a contractual obligation or an understood agreement to act in the interests of another person. Lawyers agree for a fee to represent clients, and employees are similarly hired with the understanding that they will work for the benefit of an employer.

**LIMITS TO AGENCY DUTIES** At first glance, a whistleblower is a disloyal agent who backs out of an agreement that is an essential part of the employer–employee relationship. A whistle-blowing employee, according to the loyal agent argument, is like a lawyer who sells out a client—clearly a violation of the legal profession’s code of ethics. Closer examination reveals that the argument is not as strong as it appears. Although employees have an obligation of loyalty that is not shared by a person outside the organization, the obligation is not without its limits. Whistle-blowing is not something to be done without adequate justification, but at the same time, it is not something that can never be justified.

**First, the law of agency does not impose an absolute obligation on employees to do whatever they are told.** Rather, an agent has an obligation, in the words of the *Second Restatement*, to obey all *reasonable* directives of the principal. This is interpreted to exclude illegal or immoral acts; that is, employees are not obligated as agents to do anything illegal or immoral—even if specifically instructed by a superior to do so. Questions can arise, of course, about the legal and moral status of specific acts. Is an agent free to

disobey an order to do something that is suspect but not clearly illegal or immoral, for example? Borderline cases are unavoidable, but in situations where a crime is being committed or people are exposed to the risk of serious injury and even death, the law of agency is clear: An employee has no obligation to obey.

The law of agency further excludes an obligation to keep confidential any information about the commission of a crime. Section 395 of the *Second Restatement of Agency* reads in part: “An agent is privileged to reveal information confidentially acquired . . . in the protection of a superior interest of himself or a third person.” The *Restatement* does not define what is meant by a “superior interest” except to note that there is no duty of confidentiality when the information is about the commission of a crime. “[I]f the confidential information is to the effect that the principal is committing or is about to commit a crime, the agent is under no duty not to reveal it.”<sup>23</sup> Protecting oneself from legal liability can reasonably be held to be a “superior interest,” as can preventing some serious harm to others.

**Second, the obligations of an agent are confined to the needs of the relationship.** In order for a lawyer to represent a client adequately, it is necessary to impose a strong obligation of loyalty, but the obligation of loyalty required for employees to do their job adequately is less stringent. The obligation of agents to follow orders exactly stems, in part, from the fact that they may be binding the principal to a contract or exposing the principal to tort liability. The duty of confidentiality is justified by the legitimate right of an employer to maintain the secrecy of certain vital information. Thus, Coleen Rowley was legally barred, for good reason, from divulging information about an investigation. She could not have “gone public” with her information without violating her duty as an FBI agent.

Employees are hired for limited purposes, however. As Alex Michalos points out, a person who has agreed to sell life insurance policies on commission is committed to performing *that* activity as a loyal agent. “It would be ludicrous,” he continues, “to assume that the agent has also committed himself to painting houses, washing dogs, or doing anything else that happened to give his principal pleasure.”<sup>24</sup> Similarly, a quality control inspector is not hired to overlook defects, falsify records, or do anything else that would permit a danger to exist. Information about irregularities in safety matters is also not the kind that the employer has a right to keep confidential because it is not necessary to the normal operation of a business.

To conclude, the loyal agent argument does not serve to show that whistle-blowing can never be justified. The obligations that employees have as agents of an organization are of great moral importance, but they do have limits. Specifically, the agency relation does not require employees to engage in illegal or immoral activities or to give over their whole life to an employer.

### 4.2.2: Meaning of Loyalty

The concept of loyalty itself raises some questions. One is whether whistle-blowing is always an act of disloyalty or whether it can sometimes be done out of loyalty to the organization. The answer depends, in part, on what we mean by the term “loyalty.” If loyalty means merely following orders and not “rocking the boat,” then whistle-blowers are disloyal employees. But loyalty can also be defined as a commitment to the true interests or goals of the organization, in which case whistle-blowers are often very loyal employees. Thus, whistle-blowing is not necessarily incompatible with loyalty; and, indeed, in some circumstances, loyalty may require employees to blow the whistle on wrongdoing in their own organization.

All too often, the mistake of the whistle-blower lies not in being disloyal to the organization as such but in breaking a relation of trust with a few key members of an organization or with associates and immediate superiors. Insofar as an employee has a duty of loyalty, though, it cannot be merely to follow orders or to go along with others. Loyalty means serving the interests and goals of an organization, which can sometimes lead to divided loyalties and uncertainties about what is best for an organization.

Some evidence for the claim that whistle-blowers are often loyal—perhaps even too loyal—to the organizations they serve is provided by Myron Glazer, a sociologist who interviewed 55 whistle-blowers in depth. One of his findings is stated as follows:

Virtually all of the ethical resisters . . . had long histories of successful employment. They were not alienated or politically active members of movements advocating major changes in society. On the contrary, they began as firm believers in their organizations, convinced that if they took a grievance to superiors, there would be an appropriate response. This naiveté led them into a series of damaging traps. They found that their earlier service and dedication provided them with little protection against charges of undermining organizational morale and effectiveness.<sup>25</sup>

The irony of this finding is that whistle-blowers are often loyal employees who take the first steps toward whistle-blowing in the belief that they are doing their job and acting in the best interests of the company.

As further evidence that the relationship between whistle-blowing and loyalty is far more complex than it first appears, the economist Albert O. Hirschman argues, in a book entitled *Exit, Voice, and Loyalty*, that members of organizations and people who deal with organizations, such as customers of a firm, can respond to dissatisfaction either by leaving the organization and having no further dealings with it (exit) or by speaking up and making the dissatisfaction known in the hope of bringing about change (voice). Loyalty is a factor that keeps people from exiting

an organization; but, at the same time, it activates the voice option. According to Hirschman, those who exercise the voice option are often the most loyal and are convinced that by speaking up they can get the organization back on the right track.<sup>26</sup>

On Hirschman’s analysis, exit is a more extreme form of dissent than voice, but business firms do not usually regard an employee’s departure as a form of disloyalty. In fact, whistle-blowers are often treated in ways designed to get them to leave voluntarily. It may benefit an organization in the short run to get rid of troublemakers, but Hirschman argues that in the long run, encouraging employees to use the exit option will harm the organization by depriving it of those people who can bring about healthy change. As a result of loyalty, these potentially most influential members will stay on longer than they would ordinarily, in the hope or reasoned expectation that improvement or reform can be achieved from within. Thus, loyalty, far from being irrational, can serve the socially useful purpose of preventing deterioration from becoming cumulative, as it so often does when there is no barrier to exit.<sup>27</sup>

A further complication is the fact that employees typically have a number of loyalties, both inside and outside an organization, which can come into conflict. Although employee loyalty is morally required, a company is not a single entity to which the employee owes loyalty but is, rather, a complex of individuals, groups, projects, and missions. Loyalty to one aspect of a company may require disloyalty to another. An employee may not be able to be loyal to an immediate superior whose order conflicts with loyalty to a company’s mission to provide quality service, for example. Employees are also citizens who may have a duty of loyalty to obey the law or pursue some public good. To whom should an employee be loyal when asked, for example, to discharge pollutants into a stream? Merely appealing to a general duty of loyalty does not resolve these kinds of conflicts.<sup>28</sup>

Even if we limit loyalty to a specific employer, questions about what loyalty means still arise. *The Code of Ethics for Government Service*, for example, contains the following instruction for federal employees: “Put loyalty to the highest moral principles and to country above loyalty to persons, party, or government department.” This lofty statement is a prescription for confusion when employees of an administration or an agency are called upon to be team players.

### 4.2.3: Conditions for Justification

Whistle-blowing is not something to be undertaken lightly, especially in view of the serious, often devastating consequences. In order to be sure that that whistle-blowing is justified, a potential whistle-blower should analyze the

situation carefully and accurately and also formulate an effective course of action.<sup>29</sup>

**ANALYZING THE SITUATION** The first step for a person considering whistle-blowing is the decision *whether* to blow the whistle. More specifically, the following questions require adequate consideration.

Is the situation of sufficient moral importance to justify whistle-blowing?

A cover-up of lethal side effects in a newly marketed drug, for example, is an appropriate situation for disclosure because people's lives are at stake. But situations are not always this clear. Is whistle-blowing warranted if the side effects are not lethal or debilitating but capable of causing temporary discomfort or pain? What if the drug is the most effective treatment for a serious medical problem, so that the harm of the side effect is outweighed by the benefit of using the drug? In such a case, we need to ask how serious is the potential harm compared with the benefit of the drug and the trouble that would be caused by blowing the whistle. The less serious the harm, the less appropriate it is to blow the whistle.

In addition to the moral importance of the situation, consideration should also be given to the extent to which harm is a direct and predictable result of the activity that the whistle-blower is protesting. For example, a toy that might be hazardous under unusual circumstances warrants whistle-blowing less than one that poses a risk under all conditions. Sissela Bok contends that the harm should also be imminent. According to her, an alarm can be sounded about defects in a rapid-transit system that is already in operation or is about to go into operation, but an alarm should not be sounded about defects in a system that is still on the drawing boards and is far from being operational.<sup>30</sup>

Do you have all the facts and have you properly understood their significance?

Whistle-blowing usually involves very serious charges that can cause irreparable harm if they turn out to be unfounded or misinterpreted. A potential whistle-blower, therefore, has a strong obligation to the people who are charged with wrongdoing to make sure that the charges are well founded. The whistle-blower should also have as much documentation and other corroboration as possible. A whistle-blower's case is stronger when the evidence consists of verifiable facts and not merely hunches or rumors. Because whistle-blowing cases often end up in court, the proof should also be strong enough to stand up under scrutiny. The support for the charges need not be overwhelming, but it should meet the ordinary legal standard of a preponderance of the evidence. Employees often have access to only some of the facts of a case and are liable, as a

result, to form false or misleading impressions. Would-be whistle-blowers must be careful, therefore, not to jump to conclusions about matters that higher-level managers, with a fuller knowledge of the situation, are in a better position to judge. Typically, employees have only one kind of expertise, so they are not able to make an accurate judgment when different kinds of knowledge are needed.

Have all internal channels and steps short of whistle-blowing been exhausted?

Whistle-blowing should be the last rather than the first resort. It is justified only when there are no morally preferable alternatives. The alternatives available to employees depend to a great extent on the provisions an organization makes for dissent, but virtually every organization requires employees to take up any matter of concern with an immediate superior before proceeding further—unless that person is part of the problem. Courts will generally not consider a complaint unless all possible appeals within an organization have been exhausted. Some progressive corporations have recognized the value of dissent in bringing problems to light and have set up procedures that allow employees to express their concern through internal channels. Steps of this kind reduce the need for whistle-blowing and the risks that external whistle-blowers take.

It is possible to justify not using internal channels, however, when the whole organization is so mired in the wrongdoing that there is little chance that using them would succeed. Another justification for "going public" before exhausting internal channels is the need for a quick response when internal whistle-blowing would be too slow and uncertain. Two engineers at Morton Thiokol expressed concern to their superiors about the effects of low temperature on the O-rings on the booster rockets for the *Challenger* spacecraft, but their warning never reached the officials at NASA who were responsible for making the decision to go ahead with the launch. The engineers spoke out after the *Challenger* explosion—for which they were disciplined by Morton Thiokol—but their whistle-blowing was too late to avert the disaster. To be effective, they would have had to blow the whistle before the decision was made to launch the spacecraft. This would have required them to go outside the company and contact the officials at NASA directly.

**TAKING ACTION** Once an organization member has decided that a situation justifies whistle-blowing—that is, the "whether" question has been answered—attention must turn to the critical matter of the most effective course of action, which is the "how" question.

What is the best way to blow the whistle?

Determining the most effective course of action for a determined whistle-blower requires the adequate

consideration of many factors, beginning with the following questions:

- To whom should the information be revealed?
- How much information should be revealed?
- Should the information be revealed anonymously or accompanied by the identity of the whistle-blower?

Often an anonymous complaint to a regulatory body, such as the Environmental Protection Agency or the Securities and Exchange Commission, is sufficient to spark an investigation. The situation might also be handled by contacting the FBI or a local prosecuting attorney or by leaking information to the local press. The less information that is revealed, the less likely an employee is to violate any duty of confidentiality. Employees can also reduce conflicts by waiting until they leave an organization to blow the whistle. Whistle-blowing is also more likely to be effective when an employee presents the charge in an objective and responsible manner. It is especially important that a whistle-blower stick to the important issues and refrain from conducting crusades or making personal attacks on the persons involved. Organizations often seek to discredit whistle-blowers by picturing them as disgruntled misfits or crazy radicals; intemperate, wide-ranging attacks undermine the whistle-blower's own credibility. Many whistle-blowers recommend developing a clear plan of action. Do not blow the whistle impulsively, they advise, but think out each step and anticipate the possible consequences.<sup>31</sup>

What is my responsibility in view of my role in the organization?

The justification for blowing the whistle depends not only on the wrongdoing of others but also on the particular role that a whistle-blower occupies in an organization. Thus, an employee is more justified in blowing the whistle—and may even have an obligation to do so—when the wrongdoing concerns matters over which the employee has direct responsibility. When an employee is a professional, the question of whether to blow the whistle must be considered in the context of professional ethics. Professionals, such as lawyers, accountants, and engineers, have a greater obligation to blow the whistle under some circumstances and are restricted or prohibited from whistle-blowing under others.

What are the chances for success?

Insofar as whistle-blowing is justified because of some good to the public, it is important to blow the whistle only when there is a reasonable chance of achieving that good. Whistle-blowing may be unsuccessful for many reasons. Sometimes the fault lies with the whistle-blower who fails to make a case that attracts widespread concern or to devise an effective plan of action; other times it is simply that the organization is too powerful or the public not sufficiently responsive.

## WRITING PROMPT

### Being Heard and Being Known

Why would someone presume that an anonymous whistleblower's claims are taken less seriously than those of a whistleblower who is willing to publicly expose wrongdoing? Construct a scenario where a whistleblower might act anonymously out of loyalty to the organization, rather than from a fear of reprisal or unwanted media attention.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 4.3: Right to Blow the Whistle

### 4.3 Describe the characteristics and importance of laws designed to protect whistle-blowers and key points in the debate over the moral justification of these laws

Even though whistle-blowing can be justified in some situations, the sad fact remains that courageous employees who perform a valuable public service are often subjected to harsh retaliation. Our reaction when this occurs is, "There ought to be a law!" and, indeed, many have been proposed in Congress and various state legislatures.<sup>32</sup> Few have passed, however, and there are some strong arguments against providing legal protection for whistle-blowers. In this section, we will examine the debate over the moral justification of laws to protect whistle-blowers against retaliation. It will be useful, first, to survey the existing legal protection.

#### 4.3.1: Existing Legal Protection

Legal protection for whistle-blowing is provided by an extremely complex patchwork of state and federal laws, supplemented by precedents from case law and private agreements, such as labor contracts and company personnel policies. Existing laws are very narrowly drafted with regard to the protected employee activities and the permissible employer actions. Most laws prohibit retaliatory action against employees for certain specified activities, along with a prescribed remedy for wrongful retaliation, usually reinstatement with some compensation.

Public employees of federal and state governments receive much greater protection than private sector workers, although the increasing use of outside contractors by governments, most notably the Department of Defense, has extended federal protection into the private sphere. Increasingly, whistle-blower protection is being used, especially by the federal government, to encourage the disclosure of fraud by allowing whistle-blowers to share

in the amounts recovered from legal settlements with wrongdoers.

Despite the very large number of relevant laws, the legal protection for whistle-blowers can be fairly described as limited and uncertain.

Retaliation against federal employees who report instances of waste and corruption in government is prohibited by the Civil Service Reform Act of 1978, which also set up the Merit System Protection Board (MSPB) to receive and act on complaints of retaliation.<sup>33</sup> The provisions of this legislation were strengthened by the Whistleblower Protection Act of 1989, which allows the Office of Special Counsel to represent federal employees before the MSPB and provides numerous procedural safeguards. The 2012 Whistleblower Protection Enhancement Act addressed many problematic issues, including the scope of protected activities, the available remedies, the ease and effectiveness of enforcement, and the education of employees about their rights.

Some protection for whistle-blowers in both the public and private sectors exists in the antiretaliation provisions of various pieces of federal legislation. The National Labor Relations Act of 1935 (NLRA) forbids employers to retaliate against any employee who files a charge with the National Labor Relations Board (NLRB). Title VII of the 1964 Civil Rights Act protects employees who file a charge of discrimination, participate in an investigation or proceeding connected with a charge, or oppose an activity of a company that the employee believes is discriminatory. The Occupational Safety and Health Act of 1970 also prohibits retaliation against any employee who files a complaint with the Occupational Safety and Health Administration or testifies in a proceeding.

#### **What other federal acts have antiretaliation provisions?**

Other federal acts with antiretaliation provisions include the following:

- Surface Mining Act
- Railway Safety Act
- Surface Transportation Safety Act
- Safe Drinking Water Act
- Toxic Substance Control Act
- Clean Air Act
- Water Pollution Control Act
- Energy Reorganization Act
- Solid Waste Disposal Act

The Sarbanes-Oxley Act of 2002 (SOX) also created federal whistle-blower protection for private sector employees.<sup>34</sup> Passed by Congress in response to massive fraud at Enron, WorldCom, and other companies, the act offers multiple forms of protection.

#### **What protections does Sarbanes-Oxley offer?**

Sarbanes-Oxley prohibits retaliation against any employee “for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense.”

In addition to requiring that every publicly traded company establish an independent audit committee of the board with responsibility for detecting fraud, the act supports internal whistle-blowing by mandating that all companies, whether publicly traded or not, have procedures for employees to make confidential allegations about suspected fraudulent activity.

Employees who avail themselves of SOX protection are entitled to be made whole by such means as reinstatement, back pay, and reimbursement for legal expenses, and also to receive “special damages” for such noneconomic losses as emotional distress.

Under SOX, an employer who retaliates against a whistle-blower may be subject to a fine or imprisonment or both.

Perhaps the most effective federal statute for protecting whistle-blowers is the once-moribund federal False Claims Act of 1863 (amended 1986). This Act was originally passed by Congress to curb fraud during the post-Civil War reconstruction period by allowing private citizens who blow the whistle on fraud against the government in federal procurement (e.g., defense contracting) or federal benefits programs (e.g., Social Security and Medicare) to share in the financial recovery.

#### **What protections does the False Claims Act offer?**

The False Claims Act has been updated to encourage individuals to report any fraud against the government that they observe by entitling whistle-blowers to receive between 10 percent and 30 percent of the funds recovered in any suit.<sup>35</sup> In many instances, the government will investigate and prosecute on the basis of the evidence provided by the whistle-blower, but if the government declines to prosecute, the whistle-blower can pursue legal action alone, acting on behalf of the government in a so-called *qui tam* action. If successful in the *qui tam* suit, the individual may be entitled not only to an award but also to the recovery of legal expenses.

The largest award to date was made to a former quality assurance manager for GlaxoSmithKline, Cheryl Eckard. She received approximately \$96 million from the \$750 million in penalties that the company paid to the government for selling substandard drugs to Medicare and Medicaid, and she is entitled to millions more from states that had been defrauded.<sup>36</sup>

#### **What protections does the 2010 Wall Street Reform and Consumer Protection Act offer?**

The 2010 Wall Street Reform and Consumer Protection Act (the so-called “Dodd-Frank Bill”) strengthens existing whistle-blower antiretaliation protection in other federal legislation

and introduces some new provisions for the securities markets and other areas not covered by prior legislation. Dodd-Frank includes provisions for awards to whistle-blowers similar to the federal False Claims Act and protection for employees who make disclosures to the newly created Consumer Financial Protection Bureau. In addition, it directs the Securities and Exchange Commission to create a special whistle-blower office to oversee enforcement of the whistle-blower provisions of the act.

More than two-thirds of the states have passed laws designed to protect whistle-blowers. Most of these apply only to government employees, but a few—Michigan’s Whistle Blowers Protection Act, for example—extend more widely. Most of these state statutes specify the procedures that a whistle-blower must follow to receive protection and place requirements on the persons to whom the information is disclosed and on the kind of information that the whistle-blower discloses. Another source of protection for whistle-blowers is state court decisions limiting the traditional right of employers to fire at will. These decisions protect workers against retaliation for many reasons besides whistle-blowing, but they also leave some whistle-blowers unprotected.

Use Table 4.2 to review the main whistle-blower protections and antiretaliation provisions in federal and state law.

**Table 4.2** Legal Protections for Whistle-Blowers

Federal Laws	Provisions/Protections
The Sarbanes-Oxley Act of 2002	Prohibits retaliation against whistle-blowers who are private sector employees, and entitles them to compensation for retaliation Requires all companies to have confidential reporting procedures
The National Labor Relations Act of 1935 (NLRA)	Prohibits retaliation against any employee who files a charge with the National Labor Relations Board (NLRB)
The False Claims Act	Entitles whistle-blowers to file a <i>qui tam</i> action against a company and receive 10–30% of the funds recovered in any suit, plus compensation for legal expenses
The 2010 Wall Street Reform and Consumer Protection Act (Dodd-Frank Bill)	Strengthens protections in other laws and enforces new provisions for financial markets Entitles whistle-blowers to monetary awards for violations of security laws and rules enforced by the new Consumer Financial Protection Bureau Creates a special SEC whistle-blower office
State laws	Most protect only state employees Most specify whistle-blowing procedures and other requirements for protection

### 4.3.2: Arguments against Protection

There are many problems with drafting legislation for protecting whistle-blowers.

- **First, a law recognizing whistle-blowing as a right is open to abuse.** Whistle-blowing might be used by

disgruntled employees to protest company decisions or to get back at their employers. Employees might also find an excuse to blow the whistle in order to cover up their own incompetence or inadequate performance. Alan F. Westin notes, “Forbidding an employer to dismiss or discipline an employee who protests against illegal or improper conduct by management invites employees to take out ‘antidismisal insurance’ by lodging a whistle-blowing complaint.”<sup>37</sup>

- **Second, legislation to protect whistle-blowers would encroach on the traditional right of employers to conduct business as they see fit.** It would also add another layer of regulation to the existing legal restraints on business, thereby making it more difficult for managers to run a company efficiently. The courts would be called upon to review and possibly reverse a great many personnel decisions. The likely increase in employee litigation could also, according to Westin, “create an informer ethos at work that would threaten the spirit of cooperation and trust on which sound working relationships depend.”<sup>38</sup>
- **Third, if whistle-blowing were protected by law, what should be the legal remedy for employees who are unjustly dismissed?** Reinstatement in the workplace, which is the usual remedy in union contract grievance procedures, may not be feasible in the case of employees who are perceived as being disloyal. As an alternative to reinstatement, though, whistle-blowers could be offered a monetary settlement to compensate them for the losses suffered by being wrongly dismissed. An award could be arrived at by negotiation or arbitration, or it could result by allowing dismissed employees to sue for wrongful injury.

### 4.3.3: Arguments for Protection

**The main argument in defense of a law to protect whistle-blowers is a utilitarian one that rests on the contribution whistle-blowers make to society.** There is a direct benefit in having instances of illegal corporate conduct, gross waste and mismanagement, and dangers to the public brought to light. This benefit can be achieved, the argument goes, only if whistle-blowers are encouraged to come forward and make their information known. Ralph Nader makes the further point that because employees are often the first to know about hazards, allowing them greater freedom to speak out makes it easier to enforce existing laws and to bring about desirable changes in corporate behavior.<sup>39</sup>

These benefits must be balanced against the undeniable harm that a greater incidence of whistle-blowing would have on business firms. Insofar as companies might become less efficient—because of either the greater regulation or the loss of loyalty within organizations—a right to blow the whistle is not justified on utilitarian grounds.



**A second argument for providing legal protection for whistle-blowers appeals to the First Amendment right of freedom of speech.** A distinction needs to be made, though, between the appeal to freedom of speech as a legal argument and as a moral argument. Our rights under the Constitution protect us for the most part only against acts of government and not against those of private employers. Consequently, the freedom of speech that we have as a matter of legal right does not necessarily prevent corporations from retaliating against whistle-blowers, although it does confer some protection on government employees who speak out as citizens.

Although the First Amendment right of free speech cannot be used as a *legal* argument for holding that whistle-blowing is a protected activity in the private sector, it can still be maintained that there is a *moral* right to freedom of speech and that (morally) there ought to be a law extending this right to whistle-blowers.<sup>40</sup> At least one legal scholar has urged that we recognize a right that is broader than merely freedom of speech, namely, a right to follow one's own conscience. Whistle-blowers are often led to speak out not by a desire to serve the public good but to do what they feel is morally required of them. "Thus," this writer concludes, "the interests that weigh in favor of providing legal protection to the external whistleblower are not those embodied in an employee's obligation to society, but rather those embodied in his interest as an individual to act in accordance with the dictates of conscience."<sup>41</sup>

## 4.4: Developing a Policy

### 4.4 Identify the importance of developing an effective whistle-blowing policy for an organization and the key components of such a policy

Companies have many incentives to develop a whistle-blowing policy.<sup>42</sup> No company is immune from wrongdoing, and an effective policy on whistle-blowing enables a company to deal with misconduct internally, thereby preventing embarrassing public disclosure. For a policy to be effective, however, employees must be assured that their reports will be taken seriously—which means that an investigation will be conducted and appropriate action taken. More importantly, employees must feel confident that they will not suffer any retaliation.

#### 4.4.1: Benefits and Dangers

Although companies might prefer to ignore some wrongdoing and to continue profitable but questionable practices, they can also benefit from learning about problems early and taking corrective action before the problems become public. The lack of a policy will not prevent whistle-blowing by a company's employees, and the

increasing public acceptance of whistle-blowing combined with expanded legal protection makes whistle-blowing all the more likely. The aftermath of a whistle-blowing incident also creates problems that are best avoided. In particular, dismissing whistle-blowers with legitimate complaints sends the wrong signal to other employees, and yet allowing whistle-blowers to remain in the workplace may cause tension and strife. These equally undesirable alternatives can be avoided by eliminating the need for any employee to go outside of the normal channels of communication. An effective whistle-blowing policy can have the added benefit of affirming a company's commitment to good ethics and creating an ethical corporate climate.

Whistle-blowing policies also benefit employees by providing them with a channel of communication for responding to perceived wrongdoing in the organization. Employees are likely to welcome an opportunity to express their legitimate concerns without the risk of going public with damaging information. Whistle-blowing policies involve some dangers, however. Encouraging employees to report on each other can create an environment of mistrust and intimidation, especially if people feel vulnerable to the possibility of false accusations.

#### 4.4.2: Components of a Policy

A well-designed whistle-blowing policy should include the following components.

##### 1. An Effectively Communicated Statement of Responsibility

Employees should understand that they have a responsibility to report all concerns about serious unethical or illegal conduct through the appropriate internal channels.

##### 2. A Clearly Defined Procedure for Reporting

A procedure should be established that allows employees to report their concerns in a confidential manner. The procedure should specify the persons to whom reports are to be made and the proper form, and employees should be made aware of the procedure. Some companies use an ethics "hot line" that allows employees to make a report by calling an 800 number; other companies insist that reports be made to a person's immediate superior unless that person is involved in the suspected wrongdoing. Multiple means of reporting concerns and the choice of anonymous reporting are available in some companies with whistle-blowing policies.

##### 3. Well-Trained Personnel to Receive and Investigate Reports

The success of a whistle-blowing policy depends heavily on the skill of the personnel who receive and investigate the reports from employees. Especially critical is the ability to maintain confidentiality and to conduct a fair and thorough investigation. For these reasons, the personnel should be

well-trained and have sufficient authority within the organization, and the program should be evaluated periodically for effectiveness.

#### 4. A Commitment to Take Appropriate Action

Employees must be assured that their reports of suspected wrongdoing will not be ignored or misused. Not only should the purposes of a whistle-blowing policy be effectively communicated to all employees, but the company must also assure employees by both word and deed that their reports will be used only for these purposes. The best policies also stipulate that reporting employees will be informed about the outcome of an investigation and the action taken.

#### 5. A Guarantee against Retaliation

By far, the most critical component in any whistle-blowing policy is the assurance that employees will not suffer retaliation for making reports in good faith. Retaliation can be prevented, however, only if the importance of the policy is effectively communicated to everyone in the organization and there is a credible commitment to the policy's success by top management. Companies must be on guard, of course, for employees who might abuse an ethics hot line or other reporting mechanisms for personal ends, but a fair and

thorough investigation should reveal the facts of the case apart from the reporting employee's motives.

A whistle-blowing policy by itself will neither protect an organization from wrongdoing nor prevent whistle-blowing outside of prescribed channels. A poorly designed or implemented policy also runs the risk of doing more harm than good. Still, a policy with regard to whistle-blowing is worth considering by any company that is committed to ethical conduct.

### WRITING PROMPT

#### Encouraging Internal Whistle-Blowing

Suppose your company has just created an official whistle-blowing policy. How can employees be encouraged to use it for the good of the company, its clients, customers, or others that may be affected by wrongdoing? Why might it be necessary to have a pre-existing ethical culture at the company for the policy to succeed?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## Conclusion: Whistle-Blowing

Whether or not to blow the whistle on misconduct in an organization is the most difficult decision that some people ever have to make. The decision is wrenching personally because the stakes are so high. Yet many whistle-blowers say that they could not have lived with themselves if they had stayed silent. The decision is also difficult ethically because whistle-blowing involves a conflict between two competing duties: to protect the public and to be loyal to an organization. Although loyalty is not always overriding, as the loyal agent argument holds, neither is it inconsequential. Deciding between these duties often requires that an employee exercise very careful judgment.

The one certain conclusion of this chapter is that whistle-blowing is ethically permissible under certain carefully specified conditions. (Whether it can ever be ethically required is a different question that seldom arises. Everyone has an obligation not to be a part of illegal and immoral activity, but exposing it at great risk to oneself is usually regarded as beyond what duty requires.) Blowing the whistle is only one response that an employee can make to corporate misconduct, however, and the act of whistle-blowing itself can take many different forms. So in addition to *whether* to become a whistle-blower, employees are

faced with the further question of *how* to blow the whistle in a justified manner.

Finally, it is evident that employees who are justified in blowing the whistle ought not to suffer retaliation. What ought to be done to protect whistle-blowers from this fate is less clear. A plausible case can be made for legislation in this area, but the difficulty is drafting laws that achieve the desired result without interfering unduly in the legitimate conduct of business.

## End-of-Chapter Case Studies

This chapter concludes with three case studies.

Beyond the initial questions of whether to blow the whistle and how to do so lies the equally important matter of whether the whistle-blower's objectives have been achieved. The courageous whistle-blower in "A Whistle-Blower accepts a 'Deal'" must decide whether the "deal" offered is a satisfactory resolution. The other two cases explore different aspects of the rules for qualifying as a whistle-blower under the federal False Claims Act: Must the whistle-blower be the "original"

source of the information with “direct and independent knowledge” (“A Whistle-Blower’s Quandary”), and must the whistle-blower report the information directly to the government or is reporting to one’s own employer sufficient to qualify (“Who’s a Whistle-Blower?”)?

## Case: A Whistle-Blower Accepts a “Deal”

As the head of corporate audit for a major pharmaceutical company, I was involved in the lengthy approval process that the Food and Drug Administration (FDA) requires before a new drug can be brought to market.<sup>43</sup> The reviewer for the FDA was asking some tough questions about the data supporting our application to market a new drug. Although I managed to answer the reviewer’s questions to his apparent satisfaction, doubts were beginning to form in my own mind about the reliability of the data I was defending, so I instructed my staff to get photocopies of the original research reports for me as soon as possible.

The photocopies provided evidence of “double books.” The raw data in the original reports were entirely different from the data in our FDA application and showed the new drug failing every required test. I had heard rumors of other questionable conduct by the project director, and I suspected that he was implicated in the falsification of the data, although I had no proof for any accusations. I rejected the idea of blowing the whistle on the company by telling everything to the FDA and decided instead to follow the procedure outlined in the company’s own whistle-blowing policy. Accordingly, I prepared a report stating only the facts that I could document, and I sent it to the next highest level above the person involved, which in this situation was the legal department of the corporation.

My internal whistle-blowing prompted a quick response. I was summoned to meet with the board of directors, which had a team of lawyers from an outside firm present. The original research reports had apparently been destroyed, but there was no question about the authenticity of the photocopies that I still retained because the raw data were accompanied by the researchers’ signatures and the dates of entry. After friendly but close questioning, the board of directors offered me a “deal.” They would give me all of the resources that I needed to get the drug approved by the FDA, but they promised that the drug would never be marketed. The board intended to correct the problems within the company (and the project director soon resigned), but it wanted to avoid the embarrassment of public exposure. The board’s plan was to request that approval of the drug be withdrawn afterward by telling the FDA that mistakes had been made in the marketing projections. I accepted the deal and succeeded in getting the drug

approved. The board kept its word, and 10 years later the drug is still not on the market.

After my “deal” with the board, other changes were made. Corporate policy was revised so that I no longer had ready access to company records. The FDA has the authority to conduct “surprise” audits at any time, and the policy had been to allow my office to mimic FDA audits, so that the company would always be “FDA-ready.” Under the new policy, audits must be prearranged with the department involved, and the department can stop an audit and reschedule it at any point. Finally, the department is allowed to review the audit report before it is submitted. To my knowledge, there has been no repetition of the events of 10 years ago, but my ability to uncover such misconduct has been severely limited. Oftentimes I wonder whether I should have accepted that “deal.”

### SHARED WRITING: A WHISTLE-BLOWER ACCEPTS A “DEAL”

What is your interpretation of the company’s changes to its internal auditing procedure? Is this an attempt to shut down further inquiries from the whistle-blower, or is there reasonable justification for the company’s actions? What would you advise the whistle-blower to do in order to satisfy his or her concerns at this point?

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: A Whistle-Blower’s Quandary

As a vice president for Pharmacia (which was acquired by Pfizer in 2003), Dr. Peter Rost was in charge of worldwide marketing for the drug Genotropin, which is a synthetic human growth hormone that is used to treat a limited range of hormonal deficiencies in children and the elderly.<sup>44</sup> Beginning in 1997 and continuing until 2003, Pharmacia aggressively promoted Genotropin for conditions beyond those for which the drug had received approval from the FDA. Physicians may legally prescribe an FDA-approved drug for such “off-label” use, but pharmaceutical companies are strictly prohibited from any promotional activities designed to encourage physicians to prescribe a drug for any but approved uses. However, Pharmacia attempted to persuade physicians to prescribe Genotropin for short children without any hormonal deficiency as well as for elderly patients as an antiaging therapy. Among the means used to

increase prescriptions were kickbacks to physicians in the form of all-expense-paid company-sponsored conferences, paid participation in drug studies, and lucrative consulting positions. These efforts produced results. During the period from 1997 to 2003, approximately 25 percent of all prescriptions for children and 60 percent of prescriptions for adults were for off-label use.

Dr. Rost became aware of the illegal promotional activities in his role as head of marketing for Genotropin, and he immediately protested to his superiors. After an investigation by Pharmacia, the off-label promotion activities, including the kickbacks to physicians, were curtailed but not eliminated. Soon after Pfizer's acquisition of Pharmacia, which occurred on April 16, 2003, Dr. Rost presented evidence to his new superiors of the illegal off-label marketing of Genotropin. Without Dr. Rost's knowledge, Pfizer conducted its own investigation, and exactly one month after the acquisition, on May 16, 2003, Pfizer voluntarily notified the FDA and the other relevant government agencies of the illegal off-label promotion activities and within a few days provided them with extensive documentation of the kickbacks, as well as information about the corrective actions that were being taken.

Unaware of his employer's disclosures to the federal government, Dr. Rost decided to file a complaint under the federal False Claims Act (FCA), which he did on June 5. The FCA allows private individuals to aid the federal government in investigating and prosecuting fraud in federal procurement and benefit programs, including Medicare and Medicaid. In return for the service that such whistle-blowers provide in combating fraud—which the federal government cannot practically do on its own—a complainant can receive a percentage of the amount recovered. This percentage varies greatly, depending on circumstances, but can range from roughly 10 percent to 30 percent. The FCA requires that any individual receiving an award must present information that he or she possesses from personal experience that has never been publicly disclosed. That is, a complainant must be the "original" source of the information and have "direct and independent" knowledge. These conditions are necessary in order to prevent an opportunistic use of the law to collect an award based on publicly available information.

Although the promotion of off-label use of a drug is illegal, it is not itself a violation of the FCA. Separately, Pfizer paid \$35 million to settle charges of bribery and improper promotion in connection with Genotropin. In a complaint under the FCA, it is necessary to show that the illegal promotional activity caused the submission of a false insurance claim to the government (for reimbursement from Medicare/Medicaid). Evidence that a false claim was submitted must be more specific than arguing that the illegal promotional activity was likely to cause the submission of false claims.

## Did Dr. Rost have sufficient evidence to support his complaint?

### Compare Your Thoughts

The evidence provided by Dr. Rost focused mainly on one physician, Dr. Pamela Clark, who practiced in Louisville, Kentucky. Dr. Clark, who attended several Pharmacia-sponsored conferences in exotic locales and received some compensation for various services rendered to Pharmacia, allegedly wrote Genotropin prescriptions for eight Medicaid patients to treat growth hormone deficiency (GHD), for which Genotropin is an FDA-approved use. However, Dr. Rost maintained that this use is permitted "on-label" only if the diagnosis is based on at least two tests for GHD, and Dr. Clark performed only one test for each patient. Dr. Rost presented no evidence to show that Pharmacia had encouraged doctors to perform only one test for a diagnosis of GHD. As further evidence that false claims were submitted, Dr. Rost cited 8 physicians in Indiana who prescribed Genotropin for an off-label treatment of 10 patients for whom Medicaid paid 122 claims, but he could offer no evidence that any of these physicians had ever been targeted by Pharmacia promotional activities.

The FCA further requires that a claim submitted to the federal government contain some falsehood. The Medicaid claims in question were filed by the pharmacies that processed the physicians' prescriptions. Federal law requires that any kickback in the prescription of a drug be disclosed, and so any party who does not disclose receiving a kickback is in violation of the anti-kickback law. However, the pharmacies in these cases did not receive a kickback; the physicians did, and the pharmacies in submitting the claims were certifying only that *they* had not received a kickback. A claim that Medicaid receives for reimbursement for a drug that has been improperly prescribed as the result of a kickback fails to make a required disclosure—and is in that respect false—but the fault lies with the dishonest physicians and not with the pharmacies. Pharmacia, by its illegal promotion of off-label use directed toward physicians, did not cause any pharmacy to submit a false claim.

Faced with many questions, Dr. Rost had to decide whether to proceed with filing an FCA complaint. He had acted as a whistle-blower within the organization, and in so doing he had initiated a chain of events that led Pfizer to voluntarily investigate itself and report the findings to the FDA. In the end, Pfizer ceased the illegal off-label promotional activities and settled with the government at considerable cost. Although a federal investigation continued, the Department of Justice eventually decided, after two and one-half years of consideration, not to take further action. Dr. Rost had performed a valuable service as a courageous employee, for which he suffered some on-the-job retribution<sup>45</sup> and was eventually fired.<sup>46</sup> For society, the question remains whether, as a matter of justice, he should also be rewarded with millions of dollars as a complainant under the federal False Claims Act.

## SHARED WRITING: A WHISTLE-BLOWER'S QUANDARY

Dr. Rost was not the “original” source of the information with “direct and independent knowledge” of the wrongdoing committed. Develop a case either for or against why he should be rewarded for coming forward or compensated for the loss of his job. What percentage, if any, should he receive of the \$35 million collected from Pfizer?

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Who’s a Whistle-Blower?

In June of 2010, Khaled Asadi, the head of General Electric Energy’s operations in Iraq, learned from an Iraqi government source that the company had hired a woman who was “closely associated” with the Senior Deputy Minister of Electricity “in order to curry favor with the Minister while negotiating a lucrative Joint Venture Agreement.”<sup>47</sup> The source specifically warned that GE was “pimping its way to the agreement” by employing the woman. Asadi’s suspicions had already been aroused by the rumor that a single bid had been received for the project, which was generally not permitted under Iraqi law.

Khaled Asadi, who held dual citizenship in the United States and Iraq, was employed in the U.S., but he had accepted a temporary assignment in 2006 to Amman, Jordan, where he served as GE–Iraq Country Executive for General Electric Energy, a wholly owned subsidiary of GE. Mr. Asadi was concerned that the hiring of the woman might upset the delicate negotiations that were being conducted, as well as be a violation of the Foreign Corrupt Practices Act, which might damage the company. He immediately reported the information he had acquired to two superiors in the company, and subsequently an ombudsperson for the parent company, GE, contacted and interviewed him. The negotiations were successful, and a seven-year agreement worth \$250 million was signed on December 30, 2010.

Shortly after the interview with the ombudsperson, Mr. Asadi reported that he received a “surprisingly negative” performance review, which contrasted sharply with his 10 previous favorable evaluations. The review, he claimed, did not list specific faults or offer any steps for improvement. In subsequent months, he was subjected, reportedly, to “constant and aggressive severance negotiations,” which were followed on June 24, 2011, by an emailed termination notice. The notice indicated that his employment

was being terminated as a U.S. employee in accord with U.S. law.

However, U.S. law, specifically, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, prohibits retaliation against whistle-blowers and permits a recovery of damages. In addition, the Foreign Corrupt Practices Act of 1977 and 1988 and the 2002 Sarbanes-Oxley Act, passed after the Enron scandal, contain whistle-blower protections, which are further enhanced by the federal False Claims Act. Mr. Asadi believed that he was a victim of unlawful retaliation and filed a suit under the Dodd-Frank Act. In reporting his concerns, Mr. Asadi also believed that he had followed company policy. The parent company’s *General Electric Company Code of Conduct* directed employees to report any suspected violations of company policy and assured them that no retaliation would result.

An issue in the lawsuit brought by Mr. Asadi is the definition of a whistle-blower. GE Energy argued that Mr. Asadi did not fit the wording of the Dodd-Frank Act, which prohibits retaliation only against an employee who provides information about a violation of securities law *to the Securities and Exchange Commission (SEC)*. Mr. Asadi conceded that he reported the information only internally and not to the SEC. Lawyers for GE argued, “Without any allegation that he reported a securities-law violation to the SEC, Asadi is not a ‘whistleblower’ under Dodd-Frank.” An appeals court agreed with the GE position and dismissed the suit.<sup>48</sup> The message sent to whistle-blowers, then, is that antiretaliation protection is available from the courts only if the information is conveyed externally to the proper legal authorities. Blowing the whistle in-house is not sufficient.

### Why is this the wrong message to send?

#### Compare Your Thoughts

This ruling by the courts undermines the effectiveness of companies’ own internal compliance programs by potentially discouraging employees from coming forward with allegations in the early stages of misconduct and allowing companies to police their own employees swiftly. However, during the comment period when the SEC was drafting rules for the implementation of the Dodd-Frank whistle-blower provisions, GE joined five other large corporations, including Google, JPMorgan Chase, and Microsoft, in a statement that strongly urged the commission to support their compliance programs by requiring employees seeking legal protection as whistle-blowers to report internally first.<sup>49</sup> The signatories to these comments declared, “[W]e believe that the best way to balance the desires for strong compliance functions and an effective whistleblower program is to require internal reporting to be eligible for an award except in cases where the whistleblower’s company does not maintain an effective compliance program with an acceptable reporting process.” The final SEC rules did not

contain a requirement that employees report internally to be eligible for legal protection.

A mandatory requirement to report internally would not have affected Mr. Asadi, who did just that, nor would it have affected 92 percent of all whistle-blowers who were found in a 2013 study by the Ethics Resource Center to have disclosed information internally first.<sup>50</sup> Thus, only 8 percent of whistle-blowers disclosed information solely to external parties. The same study reports that only 20 percent of whistle-blowers ever go public with their information and that a mere 9 percent reported problems to the government and thus gained any legal protection from the Dodd-Frank Act. The ineffectiveness of internal reporting at some companies is evidenced by the findings that of those reporting externally, 29 percent said that the company did not act on the disclosure, and 36 percent were not satisfied with their company's action.

Lawyers for Khaled Asadi decided not to file an appeal to the U.S. Supreme Court, which would have provided the top court with an opportunity to issue a definitive ruling

on whether a whistle-blower has the protection of law only if information is reported externally to the proper legal authorities.<sup>51</sup> An answer to this question awaits future developments.

#### SHARED WRITING: WHO'S A WHISTLE-BLOWER?

Why should the Dodd-Frank Act be modified to protect internal whistleblowers like Khaled Asadi? Why does it only seem to protect those who report wrongdoing to the SEC? What does this suggest about the perceived value or effectiveness of companies' internal programs for handling financial wrongdoing?

Review and comment on at least two classmates' responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

#### Chapter 4 Quiz: Whistle-Blowing

# Chapter 5

## Business Information and Conflict of Interest



### Learning Objectives

- 5.1** Identify the competing rights and considerations of fairness for employers and employees seeking to protect or use confidential information
- 5.2** Explain the concepts of intellectual property and trade secrets; the arguments surrounding questions of the ownership, protection, and collection of proprietary information; and how these issues affect the employer–employee relationship
- 5.3** Describe the meaning of conflict of interest, the different types of conflict of interest, and ways by which business firms can manage these situations

### Case: Barbie vs. the Bratz Girls

For more than 40 years, since her launch in 1959, Barbie dominated the fashion-doll market. As the most popular doll ever produced, Barbie contributed greatly to the profitability of its developer, Mattel. In 2001, challengers emerged in the form of pouty, sultry dolls with large lips and eyes and indeterminate but exotic ethnicity. Promoted as dolls with “a passion for fashion” and “some serious attitude,” these Bratz girls captivated the imagination of the Barbie market demographic, the 6-to-12-year-old age group, known in the industry as “tweens.” Executives at Mattel were alarmed by more than the unwelcome competition: The creator of the Bratz girls was a former employee who had approached a competitor, MGA Entertainment, with a few drawings and a crude model that he had developed while working at Mattel.<sup>1</sup>

#### Mattel’s Charges

The employee, Carter Bryant, had worked two stints at Mattel, between September 1995 and April 1998 and then again from January 1999 until October 2000. He was employed in the “Barbie Collectibles” department to design clothing and hairstyles for specialty dolls that were aimed at collectors rather than youngsters. In August of 2000, Mr. Bryant approached MGA, a small toy manufacturer located near Mattel in the Los Angeles area, and pitched the idea for the Bratz line of dolls. He signed a consulting agreement

with MGA on October 4, 2000, gave Mattel two weeks’ notice the same day, and left for new employment on October 19. During this two-week period, he worked with MGA on the new doll line, including the creation of a clay model that was made by a sculptor under Mr. Bryant’s direction.

Upon rejoining Mattel in 1999, Mr. Bryant signed an employment agreement, which included the provisions: “I agree to communicate to the Company . . . all inventions (as defined below) conceived or reduced to practice by me (alone or jointly with others) at any time during my employment by the Company. I hereby assign to the Company . . . all my right, title and interest in such inventions.” The contract further specifies that “the term ‘inventions’ includes, but is not limited to, all discoveries, improvements, processes, development, designs, know-how, data computer programs and formulae, whether patentable or unpatentable.”

About six months after Mr. Bryant’s departure from Mattel, in May 2001, MGA launched the four original dolls in the Bratz line, named Cloe, Yasmin, Sasha, and Jade. By the end of 2005, MGA had sold 125 million Bratz dolls worldwide and captured about 40 percent of the fashion-doll market, leaving Barbie a 60 percent share.<sup>2</sup> Mattel attempted to counter MGA’s Bratz line in 2002 with a redesign of Barbie in the “My Scene” series, in which this once-demure doll now had platform shoes, low-rise jeans, heavier makeup, and an exposed navel.<sup>3</sup> In 2003, Mattel introduced the urban, hip-hop Flavas line, which *Newsweek* magazine described as “ghetto-fabulous.”<sup>4</sup> At some point, Mattel became aware of Carter Bryant’s role in MGA’s development of the Bratz

dolls<sup>5</sup> and charged him with violation of his employment contract. Specifically, Mattel claimed that his drawings and the model belonged to the company and that he had also wrongfully appropriated the name “Bratz.” The drawings and model should have been turned over to his employer and certainly not shown to a competitor. Mattel further alleged that it had considered using the name “Brats” in connection with the Diva Starz doll, launched in 2000, so Mr. Bryant’s use of the similar sounding “Bratz” was also in violation of his employment contract.

## Developer’s Defense

Mr. Bryant defended his right to the drawings by claiming that he developed the idea and made the original drawings in the summer of 1998 while living with his parents in Missouri between the two stints at Mattel. The inspiration for the characters, he said, came from, among other sources, shoe ads in *Seventeen* magazine and the cover of a Dixie Chicks album. The drawings he showed to MGA, he argued, were simply transfers from these original drawings. All the work on the idea of a Bratz line was done, he claimed, on his own time and not while performing his assigned tasks at Mattel. Furthermore, these tasks did not include generating new ideas for doll lines, so work on the Bratz dolls occurred outside the scope of his employment. Also, the phrase in the employment contract, “at any time during my employment by the Company,” was ambiguous, he claimed, and could mean only during working hours and not apply to time spent away.

More crucially, the employment contract is phrased in terms of *inventions*, which it defines in some detail. No part of the definition would seem to apply to *ideas* for a new doll line. Inventions are generally regarded as concrete creations that can be implemented, while ideas are more ephemeral, existing initially only in the mind of a conceiver. For example, the idea of a machine to remove seeds from cotton fiber is different from the invention of the cotton gin. Moreover, the drawings themselves were sketchy and far removed from the eventual design of the Bratz dolls. What was original in Mr. Bryant’s idea

was not the actual appearance of the dolls themselves—which were not yet fully developed in the drawings—but the element of edginess or transgressive behavior in a doll. As one writer explains: “What Bratz dolls are both contributing to and feeding on is a culture in which girls play at being ‘sassy’—the toy industry’s favorite euphemism for sexy.”<sup>6</sup>

**Even if Mattel owned the drawings and the model that Mr. Bryant had created, would the four original Bratz dolls constitute a violation of Mattel’s property rights?**

### Compare Your Thoughts

The same question could also be raised about the other Bratz dolls developed by MGA, including Bratz Boyz, Bratz Kidz, and Baby Bratz, as well as many other Bratz characters in MGA television shows and movies. If Mattel owned the drawings, it would presumably have a right to a specific, unique expression of an idea, such that the production of any dolls by a competitor that looked virtually identical to the drawings would be a violation of their property rights, but the idea of bratty dolls itself would not seem to be protectable as a form of property. For example, the writer of a vampire novel can rightfully protect a specific character or plot (an expression) but could not prevent others from writing a novel about vampires (an idea).

Even if an expression of an idea is substantially similar without being virtually identical (which would be a kind of theft), much more contributes to success than the mere appearance of a doll. Many competitors sought to emulate Mattel’s success with the Barbie doll but failed due to the difficulties of marketing such a product, and Mattel tried but failed with dolls similar to the Bratz girls, such as Diva Starz and the Flavas line, and even with the Barbie “My Scene” series. In these failures, Mattel was attempting to use the idea, though not the expression, employed by a competitor. As for the charge of wrongfully appropriating the name “Bratz” from Mattel’s development of the Diva Starz, MGA denies that Mr. Bryant was aware of any discussions. The name was first used in 1994 for a line of children’s clothing that is sold exclusively at Costco, and it was assigned by the owner to MGA in 2002.<sup>7</sup>

## Points to Consider...

It is understandable that companies such as Mattel seek to protect sensitive *business information*. Information is a valuable corporate asset, which companies have a right, as well as a strong interest, to protect, and which employees and others may have a duty not to disclose or otherwise misappropriate. It is also important in business to manage *conflict of interest*, which is a situation in which a personal interest interferes with the ability of an individual to fulfill some obligation or duty to act in the interest of others. This chapter explores the two topics of business information and conflict of interest, with particular concerns for understanding

the ethical issues involved and the management of these issues in business practice.

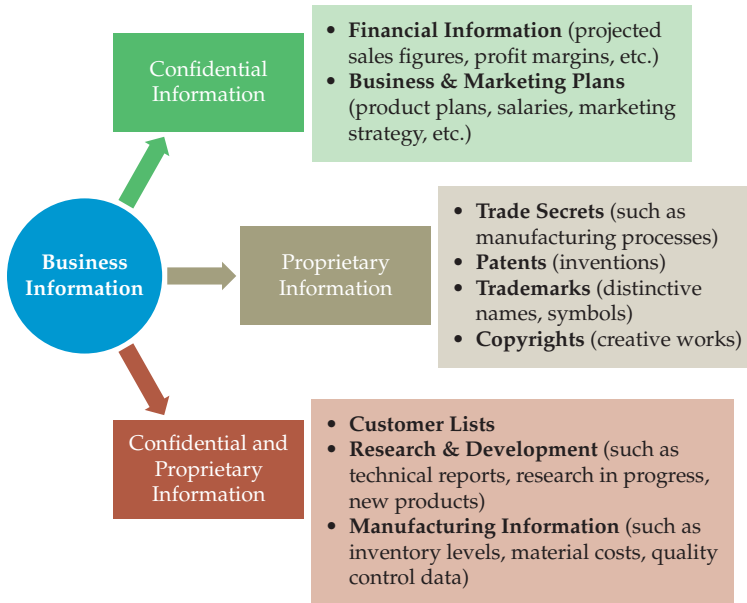
In considering business information, it is useful to make a distinction between *confidential information* and *proprietary information*. These two kinds of information are conceptually distinct, but they overlap in practice. Confidential information is internal information, which a company tries to keep secret, or “in house,” because disclosure to competitors or the public might be harmful. Generally, confidential information is known only by company insiders in the course of their employment. Proprietary information, which may or may not be confidential, is distinguished by a claim of ownership: It is information



## Figure 5.1 Business Information

What exactly is “business information”? What is the difference between “confidential” and “proprietary” information, and how do these two categories overlap?

Some information may be both confidential because a company would want to keep it from competitors and also proprietary because it may represent an investment in developing a valuable resource.



that a company can be said to own as a form of property by virtue of creating or discovering it. Examples of confidential information are sales figures, product plans, and future advertising campaigns. Propriety information, some of which is also called “intellectual property,” includes trade secrets, patents, trademarks, and copyrights. Information such as a customer list may be both confidential because a company would want to keep it from competitors and also proprietary because it may represent an investment in developing a valuable resource.

Use Figure 5.1 to review the distinguishing features of different types of business information.

The protection of both confidential information and proprietary information is of concern not only to business but also to society, since economic development depends crucially on the handling of all kinds of business information. Knowledge and innovation are the drivers of increased productivity in the economy, and the incentives to develop and utilize these critical factors would be dampened if they were not protected to some extent.

These two kinds of business information are associated with two different means of protection. Confidential information is protected mainly by the imposition of a *duty of confidentiality* on employees and others to maintain secrecy and refrain from disclosure or misappropriation. By contrast, the means for protecting proprietary information that is regarded as the property of a company is the enforcement of *property rights*, so that the taking of such information—whether it is widely known or not—is a kind

of theft. Companies make investments in information in many ways, including the development of novel ideas, the collection of useful data, and the building of strong brands. These creations, which may seem ephemeral, nevertheless constitute kinds of property that can properly be said to belong to their originators as a return on investment.

### WRITING PROMPT

#### Product Concept versus Execution

A jury found MGA guilty of interfering with the employment contract between Bryant and Mattel, but not guilty of copyright infringement. Mattel neither owned the copyright to the Bratz doll concept and drawings, nor any Bratz trademarked properties, and therefore was not awarded any share of the resulting profits.<sup>8</sup>

Give some examples of the different types of business information involved in developing, manufacturing, advertising, and selling a new and innovative product on the market, such as the Bratz dolls. Then explain whether the success of the product can be largely attributed to the initial concept and design, another single piece of confidential or proprietary information, or all of the information is equally essential.

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## 5.1: Confidential Information

### 5.1 Identify the competing rights and considerations of fairness for employers and employees seeking to protect or use confidential information

Confidentiality may be breached not merely by disclosing information to others but also by using information that belongs to a current or former employer for one’s own benefit, either in the service of another employer or by starting a business of one’s own. In the Mattel case study, if Carter Bryant’s ideas were the property of Mattel—which was a point in dispute—and he had used these ideas to start his own business instead of disclosing them to a competitor, he would still have acted wrongly. The information involved in such a wrongful act may include not only business secrets but also the training that is given to employees at an employer’s expense. This training may involve business secrets—how to perform certain specialized operations, for example—but it may also constitute a kind of property that is created merely by an employer’s investment of resources.

Both cases—the use of business secrets and the use of employer-provided training—may involve some wrong. However, neither of these uses can be addressed by means

of a confidentiality agreement, which prohibits mainly disclosure. For this reason, employers attempt to protect confidential information not only by imposing a duty of confidentiality—that is, a duty not to disclose—but also by restricting competitive employment through noncompetition agreements. Like confidentiality agreements, though, restrictions on competing with a former employer may impose an unfair burden on workers by foreclosing legitimate employment opportunities. Thus, the morality of imposing upon employees either a duty of confidentiality or a duty not to compete requires a careful balancing of both competing rights and considerations of fairness.

### 5.1.1: Duty of Confidentiality

A duty of confidentiality arises either from some relationship, such as employment, or from an explicit agreement or contract. Not only do employees have a general duty of confidentiality as agents of an employer, but they may also sign confidentiality or nondisclosure agreements, as well as noncompetition agreements, which reaffirm and reinforce agency-based duties through legally binding contracts.

A duty of confidentiality applies most notably to employees with regard to information that they acquire in the course of their employment, but issues of confidentiality also arise about information that companies possess about employees, customers, and suppliers. Employees' salaries, consumers' purchases, and suppliers' price lists, for example, may all be confidential. In addition, many business deals, such as mergers and acquisitions, require that companies share sensitive information, which, if leaked, could endanger the successful completion of a transaction. Confidentiality is also a critical concern for professionals, such as physicians, attorneys, accountants, and consultants, who are given access to sensitive information in order to provide their services.

**Example:** The ability of advertising agencies to develop campaigns for new products requires that clients share carefully guarded secrets that must be held in confidence (see Case: The Aggressive Ad Agency).

**JUSTIFYING THE DUTY** An employee's duty of confidentiality is ethically problematic for many reasons. Companies have some right to protect valuable business information, especially when an investment or a competitive advantage is involved, but employees also have the right to change jobs or to start up a business of their own using some of the skills and knowledge they have acquired in their previous employment. This kind of job mobility is critical for workers' own well-being, and companies also benefit from the right to use their own employees' skill and knowledge that may have been acquired elsewhere. Furthermore, the economic development of society is enhanced when information is allowed to flow freely through the

unfettered utilization of workers' skills and knowledge. The issues surrounding the protection of business information thus involve three parties:

1. businesses,
2. workers, and
3. society as a whole.

In many situations, the duty of confidentiality arises as part of agency and fiduciary relationships, which involve a commitment to act in another party's interest. For agents and fiduciaries, any disclosures that would inflict harm on this other party are prohibited. Thus, the third *Restatement of Agency* states, "An agent has a duty . . . not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party."<sup>9</sup> In other cases, a duty of confidentiality is based on an agreement or contract, which is imposed as a precondition for the sharing of sensitive information. For example, no company would disclose sensitive information to a consultant or a potential acquirer except under a pledge of confidentiality.

Whether a duty of confidentiality arises from a relationship or a contract—or both, as the two sources are not mutually exclusive—similar problems of interpretation arise.<sup>10</sup>

**First, in determining whether an individual has a duty of confidentiality—or whether such a duty has been breached—it is necessary to establish the existence of the duty.** Usually, this is a simple matter of establishing that a person is an agent or a fiduciary or has signed a confidentiality agreement. However, Carter Bryant claimed that the agreement he admitted signing with Mattel did not apply to ideas he developed during the time he spent between employment stints or while away from the workplace. He recognized that he had a duty of confidentiality when completing work directed by his employer but denied that this duty applied to him outside of the scope of his assigned tasks at Mattel.

**Second, anyone who is an agent or a fiduciary or who is bound by an agreement must still understand which information may not be rightly disclosed.**

What information really is confidential and thus covered by an agreement?

Again, Mr. Bryant claimed that the drawings and models he created were mere ideas, which, aside from being developed on his own time, were too sketchy to constitute the kind of information covered by the agreement. Other information might be judged as too unimportant or too well known to be truly confidential. Alternatively, the information might have been known prior to the relationship or agreement from some other source, or it might have subsequently become public through no fault of the person with a duty not to disclose. Would disclosure of such information violate a duty of confidentiality?

**CONFIDENTIALITY AGREEMENTS** These questions about a duty of confidentiality and many others are commonly addressed in the text of confidentiality or nondisclosure agreements, which are ubiquitous in business. Many employees sign, usually as a condition of employment, a confidentiality agreement, which creates an explicit contractual obligation that is often more stringent than the obligation of confidentiality that is typically created by an agency or fiduciary relationship. Confidentiality agreements are almost universally demanded by companies when they deal with consultants and a range of other business partners. Similarly, companies engaged in mergers and acquisition negotiations insist that all parties agree to treat all shared information as confidential. In addition to being more stringent, a duty of confidentiality created by an agreement or contract may also not end with the termination of employment but may continue to exist after an employee leaves one job for another.

Although confidentiality agreements have some benefits for both employers and employees, they are subject to one notable ethical objection. Because they are usually required as a condition of employment, employees are effectively coerced into giving up rights to which they would otherwise be entitled. By relying on a legally enforceable duty of confidentiality, companies place a significant restraint on employee mobility and career prospects. Even if employees sign a confidentiality agreement, the coercive conditions under which they do so bring into question the extent to which their consent is willingly or voluntarily given. Since willing or voluntary consent is necessary for any agreement to have moral, as well as legal, binding force, its lack in confidentiality agreements raises serious ethical concerns.

These ethical concerns can be countered by employers' rights to protect confidential information and by the benefits gained by workers in signing confidentiality agreements. The justification for requiring employees to sign such an agreement is strengthened to the extent that confidential information is important to a company and is, consequently, common in the industry. Companies in high-tech industries, for example, depend heavily on their ability to protect critical information, while the dependence on secrecy is much less critical in businesses involving basic consumer products. Moreover, employees in high-tech industries are, in general, well-compensated and have ample opportunities to advance their careers without violating any confidentiality agreements.

The ethical point at issue is whether the harm to employees from the coerced restraint that is created by confidentiality agreements is outweighed by the benefit that employers gain from insisting on the signing of these agreements as a condition of employment. The justification of confidentiality agreements thus involves a careful balancing of the rights and interests of both employers and

employees, which can be done, perhaps, only on a case-by-case basis. In addition, the interest of society as a whole in promoting economic development must also be considered in determining the proper balance.

An important factor in justifying confidentiality agreements is whether the proper balancing of the rights and interests at stake could be achieved by other means that are less objectionable. Michael S. Baram contends that the use of agreements or contracts rarely preserves either the secrecy of company information or the liberty of employees, and that both of these ends are better served by means of more sophisticated management.<sup>11</sup> Among the policies he suggests are:

- improving security procedures in the workplace;
- securing the legal protection of patents, copyrights, and trademarks whenever possible;
- segmenting information so that fewer people know the full scope of a trade secret;
- limiting information to those with a need to know; and
- using increased pensions and postemployment consulting contracts to keep employees from taking competitive employment.

In addition, the incentive for employees to leave with valuable information can be reduced by greater recognition of employees for their contributions. Not infrequently, employees go to a competitor or set up a business of their own because of a feeling that they have not been fairly treated. Baram concludes that the key to protecting confidential information lies in improved employee relations, in which both employers and employees respect the rights of the other and take their obligations seriously. And a key element in improving employee relations is an ethical climate of fair play. Employers might find that treating employees fairly provides more protection for confidential information than reliance on the law.

### 5.1.2: Competitive Employment

Because of the difficulty of using confidentiality agreements to protect sensitive information after workers leave, many companies have chosen instead to require employees to sign a noncompetition agreement, usually at the time of hiring. These agreements typically restrict an employee from working for a competitor in comparable jobs, for a certain period of time, within a given geographical region after leaving a company.

Noncompetition agreements are especially common, and arguably more justified, for high-level executives and highly creative people who typically possess the most valuable secrets in an organization. Their departure for competitive employment has the potential to seriously damage the company they leave behind. Imposing a duty of confidentiality on such employees is often an ineffective safeguard,

since it may be humanly impossible for them, even with the best of intentions, not to utilize, perhaps unconsciously, the skills and knowledge that they carry away. The sale of a business also usually involves a noncompetition agreement, since much of the value for the buyer lies in the customer base, which would be eroded if the former owner re-opened nearby.

### 5.1.3: Impact of Restrictions

In many cases, the impact of the restrictions on future employment falls on well-to-do individuals who are amply compensated for any burden that these agreements impose. However, the *Huffington Post* reported in October 2014 that the sandwich chain Jimmy John's required its low-wage sandwich makers and delivery drivers to sign an agreement that prohibited them from working at a competing sandwich shop for a period of two years after leaving the company.<sup>12</sup> A competitor was defined in the agreement as any business that earned more than 10 percent of sales from similar-style sandwiches and was located within three miles of any Jimmy John's shop. Noncompetition agreements have been imposed for such entry-level, often temporary jobs as camp counselor, student intern, and hair stylist.<sup>13</sup>

The wide imposition of noncompetition agreements has been criticized as employer overreach: gaining a significant competitive advantage simply because they can, without offering workers any benefit in return. With jobs in short supply, desperate workers may simply acquiesce, if indeed they are even aware of the rights they are signing away. Highly compensated workers, by contrast, are in a stronger position to bargain, and they may be willing to accept restrictions on job mobility in return for the benefits of the offered job, especially high pay. If employers are willing to pay for the benefits that they gain from noncompetition agreements, then the loss of job mobility for workers can be a fair bargain. However, workers who are forced to accept this loss without any compensating benefits are, arguably, the victims of unfair treatment.

**NONCOMPETITION AGREEMENTS** Like confidentiality agreements, noncompetition agreements require justification because of their coercive nature and the arguably unfair constraints that they place on workers' job mobility. Noncompetition agreements are almost entirely for the benefit of employers and impose a burden on employees that may be out of proportion to any gain. The restrictions on job mobility were less of a burden at a time when workers stayed with one company for the whole of their career or moved only once or twice in a lifetime. Today, movement between jobs is much more frequent due, in part, to life in a "free agent era," in which businesses, workers, and society benefit from the opportunity to employ the best talent, especially in the technology and media sectors.

Another drawback to noncompetition agreements is that they typically apply regardless of the conditions under which employment is terminated, and so they may continue to be binding even in cases of involuntarily dismissal, which adds insult to injury for fired workers. In addition, an agreement may continue to bind a worker whose company is merged or acquired, with the result that a wider range of employment would be considered competitive than at the time of the signing. Finally, if noncompetition agreements are intended merely to limit competition rather than to protect sensitive information, then they undermine the beneficial workings of a competitive marketplace.

A few states (most notably, California) consider noncompetition agreements to be so unfair that they are prohibited entirely, while others place restrictions on them.<sup>14</sup> Where noncompetition agreements are permitted by law, the courts have generally imposed a number of tests to determine whether they are justified.<sup>15</sup> These tests are that the restrictions contained in an agreement

1. must serve to protect legitimate business interests,
2. must not be greater than that which is required for the protection of these legitimate interests,
3. must not impose an undue hardship on the ability of an employee to secure gainful employment, and
4. must not be injurious to the public.

Legitimate business interests include the protection of proprietary information or customer relations, but the purpose of an agreement cannot be merely to protect an employer against competition.

In determining whether restrictions are greater than those required to protect the legitimate interests of an employer, three factors are important. These are the time period specified, the geographical area, and the kind of work that is excluded. The value of confidential information is reduced over time, so that a noncompetition agreement designed to protect important secrets can justifiably restrain an employee only during the time when they have value. Without a time limit on an agreement, an employee could be prevented from working for a competitor even after formerly confidential information becomes common knowledge. Similarly, an employer with a legitimate interest in protecting the customers it serves in New York City, for example, might be justified in preventing a sales representative from working for a competitor in that area but not elsewhere.

Noncompetition agreements that specify the kind of work too broadly also run the risk of hampering an employee unduly. In one case, a woman in Georgia signed a contract with an employment agency in which she agreed not to work in any capacity for a period of one year for any competitor within a 25-mile radius. The Supreme Court of Georgia ruled that the time period and the area were reasonable

but that the phrase “in any capacity” was unreasonably broad, because it would bar her from doing any work for a competitor and not merely the work that she had done for her former employer.<sup>16</sup> Generally, agreements prohibiting employees from working on a particular project or soliciting specific clients, for example, are less likely to be objectionable than vague restrictions, such as writing computer programs or selling insurance.

## 5.2: Proprietary Information

### 5.2 Explain the concepts of intellectual property and trade secrets; the arguments surrounding questions of ownership, protection, and collection; and how these issues affect the employer–employee relationship

Proprietary information is a broad category that includes not only trade secrets, which depend on genuine secrecy, but also publicly disclosed patents, copyrights, and trademarks. These kinds of information are commonly regarded in the law as *intellectual property*, which can be said to belong to an owner. Patents, copyrights, and trademarks, in particular, are like tangible property in that the owner has a right of exclusive use and the right to sell, license, or otherwise assign ownership to others. This right does not depend on keeping the information secret. Ownership of a trade secret, by contrast, does not confer a right of exclusive use but only a right not to have the secret misappropriated or wrongfully acquired by others. Once a trade secret is widely known, it ceases to be protectable. All forms of intellectual property are unlike tangible property, however, in that they are not inherently exclusive; that is, their use by one person does not preclude their use by another.

### 5.2.1: Intellectual Property

The main justification for treating ideas as property is the widely accepted view that we own the results of our own labor.<sup>17</sup> Patent and copyright laws are based, in part, on the premise that inventors, writers, and other creative people who work with their minds and turn out such products as blueprints and novels should have the same right of ownership that is accorded to producers of more tangible objects, such as farmers and boat builders. However, insofar as intellectual property is created by individuals who have been hired by a company for that purpose and paid for their labor, it follows from this justification that the company is the rightful owner. Just as the products made on an assembly line belong to the company and not to the workers who make them, so too do inventions made by people who are “hired to invent,” since the company has paid them for their efforts and provided them with the wherewithal to do their work.

In addition, there are good utilitarian reasons for holding that creators have property rights in ideas.

- First, society generally benefits from the willingness of individuals and companies to innovate, but without the legal protection provided by patent and trade secret laws, there would be less incentive to make costly investments in research and development. Novelists might be less willing to entertain us with wondrous tales, and pharmaceutical firms may be less willing to develop new drugs.
- Second, patent and copyright laws encourage a free flow of information, which leads to additional benefits. Patent holders are granted a period of 17 years in which to capitalize on their discoveries, but even during the period of the patent, others can use this information in their research and perhaps make new discoveries. Commonly called “the grand patent bargain,” this requirement of full public disclosure in exchange for an inventor’s right of control for a fixed period of time seeks to maximize social benefit.<sup>18</sup>

The existence of legal protection for intellectual property also has its drawbacks. A patent confers a legal monopoly for a fixed number of years, which raises the price that the public pays for the products of patent holders during that time. Trade secrets permit a monopoly to exist as long as a company succeeds in keeping key information out of the hands of competitors. Because there is no requirement that patents be used, a company could conceivably patent a large number of processes and products that rival its own and thereby prevent competitors from using them. The owner of copyrighted material can prevent the wide dissemination of important information either by denying permission to print it or by charging an exorbitant price. These drawbacks can be minimized, though, by finding the optimal trade-off between the advantages and disadvantages of providing legal protection for patents, trade secrets, and the like. Patents, for example, are of limited duration in order to balance the competing concerns of providing an adequate return for inventors to encourage discovery and of benefiting society with free access to discoveries once patent protection expires.

Patents, copyrights, and trademarks raise many other difficult questions, which are not addressed here at any length. Disputes often arise over the ideas that can be patented. Apple, for example, lost a suit against Microsoft when a court ruled that the “look and feel” of a computer operating system (copied in Windows) could not be patented, but Amazon was able to defend its one-click ordering system as a patentable “business method” discovery. Whether modified human genes can be patented continues to be a subject of intense legal controversy that has been addressed by the courts only recently.<sup>19</sup> Also at issue are

such questions as how original an idea must be to gain patent protection and the conditions under which a competitor can be said to have infringed on a company's patent. More general ethical questions have been raised over the fairness of patent protection for less-developed countries, especially when it restricts technology transfer and access to medicines.

The main ethical controversy over copyrights concerns the time limits of the protection they offer. The Copyright Term Extension Act of 1998 greatly extended the period of time for the protection for copyrighted material, especially for works with corporate authorship.<sup>20</sup> The legislation was criticized as unwarranted corporate welfare since it protected the future income streams of a few fortunate copyright owners; and because of heavy lobbying by the Walt Disney Company, which had a great deal to gain, it was derided as the Mickey Mouse Protection Act. Thanks to Congress, Mickey and Minnie will not soon enter the public domain.

The focus of this section is on trade secrets, which pose a complex set of problems about the rights and obligations of companies possessing valuable information, as well as the rights and obligations of employees and competitors. The courts have long struggled with these problems without much success. Even what information constitutes a trade secret is a source of contention.

### WRITING PROMPT

#### Shared Ownership of Intellectual Property

Intellectual property may be created by an individual or the combined efforts of a group. How might fair joint ownership of the property be determined in the case of group collaboration, such as with multiple founders of a start-up company? What difficulties in assigning ownership would you anticipate in these cases? Use an example to help explain your reasoning.

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## 5.2.2: Defining Trade Secrets

A rough definition of a trade secret is that it is information used in the conduct of a business and is not commonly known by others. Section 757 of the *Restatement of Torts* defines a trade secret as follows:

A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it.

Examples of trade secrets include the ingredients or chemical composition of a product, the design of a machine, the details of a manufacturing process, the application of a technology, methods of quality control, results

of marketing surveys, financial projections, and lists of customers and suppliers.

A distinction is made in the *Restatement* between trade secrets and confidential business information. The latter is information concerning specific matters, such as the salary of an employee, which is kept secret but not actually used to manufacture anything or provide a service. The amount of a specific bid is also not a trade secret, but the procedure of a company for calculating bids might be. A former employee who is knowledgeable about the bidding procedure of a company, for example, might be able to use that information to enter lower bids.

The *Restatement* admits that an exact definition is not possible, but it lists six factors that can be used to determine what information is protectable as a trade secret. These are

1. the extent to which the information is known outside a company;
2. the extent to which it is known by employees and others inside a company;
3. the extent of measures taken by a company to guard the secrecy of the information;
4. the value of the information to a company and its competitors;
5. the amount of effort or money expended by a company in developing the information; and
6. the ease or difficulty with which others could properly acquire or duplicate the information.

Prior to 1996, trade secrets were protected only by state laws, except where government information was involved. Subsequently, Congress made the theft of trade secrets a federal offense by passing the Economic Espionage Act of 1996 (EEA).<sup>21</sup> The EEA is intended to prevent the theft of trade secrets for the benefit of foreign governments, which has been estimated to cost U.S. firms tens of billions of dollars annually. This legislation criminalizes, with monetary penalties and prison sentences, the theft of trade secrets with the intent of benefiting a foreign country by a U.S. citizen or by an organization based in the United States, regardless of where the theft occurs, or by any person or organization when the theft takes place in the United States. Although the EEA is aimed primarily at foreign espionage, some observers consider the domestic provisions of the act to have a greater impact.<sup>22</sup>

The EEA defines theft very broadly as the knowing misappropriation of a trade secret without the owner's consent. It also defines a trade secret broadly, as follows:

All forms and types of financial, business, scientific, technical economic, or engineering information . . . if (a) the owner thereof has taken reasonable measures to keep such information secret; and (b) the information derives independent economic value, actual or potential, from not being generally known to, and to being readily ascertainable through proper means by the public.

Because of these definitions, many trade secret disputes between companies could be subject to criminal prosecution, and every company needs to be more careful in the acquisition of a competitor's information.

There are three major arguments for trade secret protection.

- One argument views trade secrets as a kind of property and attempts to apply common-law principles of *property rights* to them.
- In the second argument, cases involving trade secrets are considered in terms of the right to compete and the principles of *fair competition*.
- The third argument holds that employees who disclose trade secrets to others or who use them for their own gain violate an obligation of *confidentiality* that is part of the employer–employee relationship.

### 5.2.3: Property Rights Argument

Imagine an inventor who, after years of hard work, develops an improved process for manufacturing a common product and builds a factory to turn out the product using the new process. Even if the innovations are not sufficiently original to be patentable, we can accept that this person owns the results of his or her creative efforts, at least to the extent that it would be wrong for a worker in the factory to disclose the details of the manufacturing process to a competitor, especially if the employee had been sworn to secrecy.<sup>23</sup>

The question of who owns what becomes more complicated if the inventor is employed by a manufacturer of the product in question. As long as the idea comes while performing unrelated work for the employer or away from the job, it seems only right that this person be recognized as the sole owner of the improved manufacturing process and be permitted to sell the secrets of the process to another manufacturer or to go into business alone. If, on the other hand, the person is hired as an inventor to develop improved methods of manufacture or does creative work on the employer's time with the resources of the employer, then some or all the rights of ownership could reasonably be claimed to belong to the employer.

**THE WEXLER CASE** The case of *Wexler v. Greenberg* is instructive in this regard. Alvin Greenberg was employed as chief chemist for the Buckingham Wax Company, which manufactured floor cleaners, polishes, and other maintenance materials. One of his tasks as the chief chemist was to analyze the products of competitors and to use the results to develop new formulas. After eight years with the company, Greenberg left to join Brite Products, which had previously purchased exclusively from Buckingham. With the formulas that Greenberg had developed while working for Buckingham, Brite was able to dispense with Buckingham as a supplier and become a manufacturer itself. Buckingham

immediately sued to prevent Greenberg and his new employer from using the formulas on the grounds that they were trade secrets that Greenberg had misappropriated.

#### Who owned the formulas: Greenberg (the inventor) or Buckingham (his former employer)?

##### The Court's Decision

According to the decision in this landmark case, an employer has the burden of showing two things: "(1) a legally protectable trade secret; and (2) a legal basis, either a covenant or a confidential relationship, upon which to predicate relief."<sup>24</sup> Information is protectable as a trade secret, in other words, only as long as it meets certain conditions, one of which is that it is genuinely a secret. Furthermore, the owner of a trade secret is protected against the use of this information by others only when it is disclosed by an employee in violation of an obligation of confidentiality, for example, or when a competitor obtains it by theft, bribery, industrial espionage, or some other impermissible means.

In overturning a lower court ruling that held that Greenberg had an obligation of confidentiality not to disclose the formulas, the Supreme Court of Pennsylvania ruled in favor of Greenberg citing the fact that the supposed trade secrets had not been disclosed to Greenberg by his employer but had been developed by Greenberg himself. The court explained,

The usual situation involving misappropriation of trade secrets in violation of a confidential relationship is one in which an employer *discloses to his employee* a pre-existing trade secret (one already developed or formulated) so that the employee may duly perform his work. . . . It is then that a pledge of secrecy is impliedly extracted from the employee, a pledge which he carries with him even beyond the ties of his employment relationship. Since it is conceptually impossible, however, to elicit an implied pledge of secrecy from the sole act of an employee turning over to his employer a trade secret which he, the employee, has developed, as occurred in the present case, the appellees must show a different manner in which the present circumstances support the permanent cloak of confidence cast upon Greenberg.

The formulas, moreover, were not significant discoveries on Greenberg's part but were merely the result of routine applications of Greenberg's skill as a chemist. As such, they were, in the court's view, the kinds of technical knowledge that any employee acquires by virtue of being employed. Even though the formulas are trade secrets, which the Buckingham Wax Company is permitted to use, they properly belong to Greenberg, who has a right to use them in his work for a new employer.

Society also makes an investment in the development of information; it is not the exclusive property of an individual or a firm. Because patentable ideas and other innovations are generally built on foundations that have been laid by others, even companies that have spent a great deal for research cannot claim sole right of ownership.

**CLARIFYING OWNERSHIP** Many companies attempt to clarify the ownership of patentable ideas by requiring employees to sign an agreement turning over all patent rights to the employer. Such agreements are morally objectionable, however, when they give companies a claim on discoveries that are outside the scope of an employee's responsibilities and make no use of the employer's facilities and resources.<sup>25</sup> Courts in the United States have often invalidated agreements that force employees to give up the rights to inventions that properly belong to them. The laws in most of the other industrialized countries of the world provide for sharing the rights to employee inventions or giving additional compensation to employees, especially for highly profitable discoveries.<sup>26</sup>

The ownership of ideas is a difficult area, precisely because the contributions of employers and employees are so difficult to disentangle. Arguably, the law in the United States has tended to favor the more powerful party, namely, employers. Contracts or other agreements that spell out in detail the rights of employers and employees are clearly preferable to ambiguous divisions that often land in the courts. These arrangements must be fair to all concerned, however, and granting employees a greater share of the rewards might be a more just solution—and also one that benefits corporations in the long run by motivating and retaining talented researchers.

#### 5.2.4: Fair Competition Argument

The second argument for trade secret protection holds that companies are put at an unfair competitive disadvantage when information they have expended resources in developing or gathering can be used without cost by their competitors. Even when the information is not easily classifiable as property and there is no contract barring disclosure or use of the information, it may still be protected on grounds of fairness in trade.

**A RIGHT TO COMPETE** In *Wexler v. Greenberg*, the court considered not only who owned the formulas that Greenberg developed for the Buckingham Wax Company but also whether placing restrictions on Greenberg's use of the formulas in his work for another company unfairly deprived him of a right to compete with his former employer. According to the decision in *Wexler*,

Any form of post-employment restraint reduces the economic mobility of employees and limits their personal freedom to pursue a preferred course of livelihood. The employee's bargaining position is weakened because he is potentially shackled by the acquisition of alleged trade secrets; and thus, paradoxically, he is restrained because of his increased expertise, from advancing further in the industry in which he is most productive. Moreover . . . society suffers because competition is diminished by slackening the dissemination of ideas, processes and methods.

The problem of trade secrets, in the view of the court, is one of accommodating the rights of both parties: "the right of a businessman to be protected against unfair competition stemming from the usurpation of his trade secrets and the right of an individual to the unhampered pursuit of the occupations and livelihoods for which he is best suited."

**ASSOCIATED PRESS CASE** A good illustration of the fair competition argument is provided by a 1918 case, in which the Associated Press complained that a news service was rewriting its stories and selling them to newspapers in competition with the Associated Press.<sup>27</sup> The defendant, International News Service, argued in reply that although the specific wording of a news story can be regarded as a form of property, like a literary work, which belongs to the writer, the content itself cannot belong to anyone. Furthermore, there is no contract between the parties that International News Service had breached.

#### Is there any merit to this argument?

##### One member of the Supreme Court agreed

In the words of Justice Louis D. Brandeis:

An essential element of individual property is the legal right to exclude others from enjoying it. . . . But the fact that a product of the mind has cost its producer money and labor, and has a value for which others are willing to pay, is not sufficient to insure to it this legal attribute of property. The general rule of law is, that the noblest of human productions—knowledge, truths ascertained, conceptions, and ideas—become, after voluntary communication to others, free as the air to common use.

In this view, information that cannot be patented or copyrighted has the same legal status as trade secrets, so that a plaintiff must show that there is a breach of contract or some other wrongful means of acquisition. Accordingly, Brandeis continued,

The means by which the International News Service obtains news gathered by the Associated Press is . . . clearly unobjectionable. It is taken from papers bought in the open market or from bulletins publicly posted. No breach of contract, or of trust and neither fraud nor force, are involved. The manner of use is likewise unobjectionable. No reference is made by word or act to the Associated Press. . . . Neither the International News Service nor its subscribers is gaining or seeking to gain in its business a benefit from the reputation of the Associated Press. They are merely using its product without making compensation. That, they have a legal right to do; because the product is not property, and they do not stand in any relation to the Associated Press, either of contract or trust, which otherwise precludes such use.

A majority of the justices of the Supreme Court sided with the Associated Press, however, arguing that the case



should be decided not on grounds of property rights or breach of contract but on considerations of fair competition.

### Did International News Service Act unfairly?

#### Read the Supreme Court's majority opinion

We need spend no time, however, upon the general question of property in news matter at common law, or the application of the Copyright Act, since it seems to us the case must turn upon the question of unfair competition in business. . . . The underlying principle is much the same as that which lies at the base of the equitable theory of consideration in the law of trusts—that he who has fairly paid the price should have the beneficial use of the property. It is no answer to say that complainant spends its money for that which is too fugitive or evanescent to be the subject of property. That might . . . furnish an answer in a common-law controversy. But in a court of equity, where the question is one of unfair competition, if that which complainant has acquired fairly at substantial cost may be sold fairly at substantial profit, a competitor who is misappropriating it for the purpose of disposing of it to his own profit and to the disadvantage of complainant cannot be heard to say that it is too fugitive and evanescent to be regarded as property. It has all the attributes of property necessary for determining that a misappropriation of it by a competitor is unfair competition because contrary to good conscience.

Although the public may make unrestricted use of the information contained in news stories, the two parties were direct competitors in a business in which the major stock in trade is news, a product that requires the resources and efforts of a news-gathering organization. In selling news stories based on dispatches from the Associated Press, the International News Service was, in the words of the majority opinion, “endeavoring to reap where it has not sown, and . . . appropriating to itself the harvest of those who have sown.”

Fairness in competition must be balanced, however, against the undeniable benefit to the public of the liberal dissemination of news. This balancing act is especially acute in the Internet age, as websites operating as “aggregators” adopt a business model of generating revenue by linking readers with news stories from published sources.

#### WRITING PROMPT

##### Fair Competition among News Aggregators

Although the *New York Times* still owns its stories, others are making money by aggregating this content. Explain whether aggregators violate the intellectual property rights of the original publishers.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 5.2.5: Competitor Intelligence

Not all use of a company's trade secrets and other proprietary and confidential business information is unethical or illegal. The systematic collection and analysis of competitor intelligence has become an accepted practice in the corporate world, and companies that do not utilize this valuable tool may find themselves at a disadvantage. This is especially true in a global environment where some of America's competitors have long-established and highly efficient intelligence units.

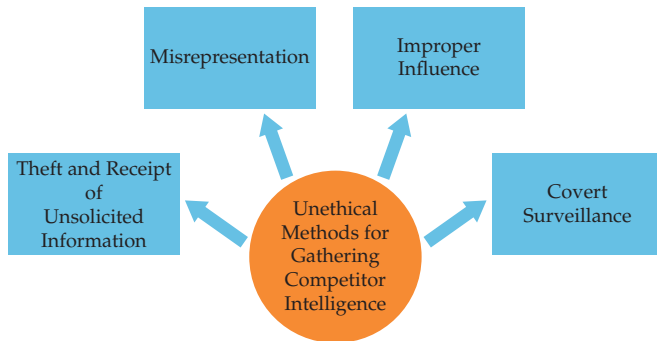
**COLLECTION PRACTICES** Computers have greatly facilitated competitor intelligence gathering, first, by making immense volumes of information available in open-access databases and, second, by enabling companies to store and sort through the information they have compiled. Much of the information used for intelligence purposes is publicly available from news sources, trade publications, court records, regulatory filings, and presentations at industry meetings, and some is also obtained from employees' own contacts with customers, suppliers, and even competitors themselves. The challenge is to piece the information together so that conclusions can be drawn.

Although competitor intelligence gathering has shed its unsavory cloak-and-dagger image, it still has ethical and legal limits that companies ignore at their peril. Unethical collection practices often lead to costly litigation and possibly to criminal prosecution under the Economic Espionage Act (EEA) of 1996. The outcome of any legal action is uncertain because of confusion in the law. A lack of ethics in competitor intelligence gathering also creates a climate of mistrust that hampers normal business activity and forces companies to adopt costly defensive measures. Most importantly, companies that routinely cross ethical boundaries in gaining competitor intelligence can scarcely expect others to respect their own trade secrets and confidential business information.

The ethical and legal limits on competitor intelligence gathering are generally concerned with the *methods* used to acquire the information.<sup>28</sup> The importance of the method of acquisition is due to the point that trade secrets are protected, according to the *Wexler* decision, only if there is a legal basis “upon which to predicate relief,” which means that some *duty* has been breached. The duties in question are most often breached by using improper methods to acquire information from a competitor. Thus, a company that carelessly allows a trade secret to become known has no right to prevent competitors from using it. Companies do have a right, however, to prevent the use of a trade secret that is sold by an employee, for example, or stolen by a competitor, because theft is present in both cases and there is a duty not to steal.

**UNETHICAL METHODS** The unethical methods for gathering competitor intelligence can be grouped under the four headings shown in Figure 5.2. Each type of method involves a breach of a particular duty.

**Figure 5.2** Unethical Methods for Gathering Competitor Intelligence



1. **Theft and Receipt of Unsolicited Information.** Theft of information, either by an employee or by an outsider, is obviously an improper method for acquiring information because it involves a violation of *property rights*. Examples of employee theft include freely offering information to competitors to take revenge, selling it for monetary reasons, and taking it to a new job in order to advance one's career. Companies that receive the information, for whatever reason it is offered, are receiving, in effect, stolen property. More controversial, however, are cases in which an employee inadvertently leaves a document where it can be seen or taken by a competitor or carelessly discloses information in casual conversation or a misdirected e-mail message. Suppose that a competitor's bid on an important project is accidentally enclosed along with the specifications that are sent by the customer. Would it be ethical to use that knowledge in preparing one's own bid? Or does the information still belong to the competitor?
2. **Misrepresentation.** To gain information under false pretenses is a form of deception that violates the duty to be *honest* in all dealings. Posing as a customer to obtain information from a competitor, for example, is an act of dishonesty. Other devious practices include asking consulting firms to solicit information from competitors under the guise of doing a study of the industry and getting friendly customers to make phony requests for bids from competitors, which might contain confidential technical information about the bidder's products. Because useful bits of information are sometimes picked up during job interviews with a competitor's employees, some companies have advertised and conducted interviews for positions that do not exist, in the hope that some applicants would inadvertently reveal trade secrets of their present employer.<sup>29</sup>

3. **Improper Influence.** The employment relation is built on *trust*, and to induce an employee to reveal information through bribery or some other means is to exert an improper influence that undermines that trust. An employee who accepts a bribe and turns over a company's secrets has broken a bond with the employer, but the company that offers the bribe has obtained those secrets by inducing that break. Improper influence can be exerted not only by bribery but also by promising or holding out the possibility of a job or some other opportunity. Offering to purchase from a supplier in return for a competitor's price list would be an example of improper influence. More direct would be plying a competitor's employee with drinks in order to make that person less discrete.
4. **Covert Surveillance.** Some methods for obtaining information intrude in ways that companies have not anticipated and taken steps to prevent. These can be said to violate a company's right to privacy. Employees who talk about confidential matters in a public place, for example, can have no expectation of privacy, but planting hidden microphones in a competitor's place of business is a form of espionage that intrudes into an area that is regarded as private. Virtually all of the high-tech gadgetry that government intelligence agencies use to spy on enemies abroad is available for competitor intelligence gathering at home. Whether corporations have a right to privacy is controversial, but if covert surveillance were to become an accepted practice, companies would be forced to take costly defensive measures. Respecting a company's reasonable expectations of privacy, then, is in everyone's best interests.

The importance of ethics in competitor intelligence gathering has led some companies to adopt policies that give employees firm guidelines on acceptable practices and also set the tone for practices within their industries. Not only can a well-designed policy protect a company from the consequences of unethical or illegal intelligence gathering, but it can also enable a company to gain the maximum benefit from competitor intelligence by making the ethical and legal limits known to all employees. Companies can protect themselves from prosecution under the EEA by showing that any illegal conduct by an employee was in violation of an effective EEA-compliance program.

## 5.3: Conflict of Interest

- 5.3** Describe the meaning of conflict of interest, the different types of conflict of interest, and ways by which business firms can manage these situations

Among the many ethical problems in the infamous collapse of Enron Corporation, conflict of interest looms

large. A report of the Enron board of directors assigns much of the blame to a host of partnerships set up by Andrew S. Fastow, the company's former chief financial officer (CFO). These partnerships had the effect of removing from Enron's books unwanted assets and liabilities and/or of adding phantom revenue. They also greatly enriched Mr. Fastow along with other top Enron executives and favored investors. These supposedly independent entities contributed to Enron's demise because they created liabilities for the company should the price of Enron stock fall, as it did.

### Case: Enron

The conflict of interest for Mr. Fastow arose when he negotiated the terms of the deals on behalf of the partners with a company that he had a duty to serve. He was in effect bargaining with himself over matters in which he stood to gain. In some negotiations involving Enron payments to the partnerships, he reportedly did not reveal his stake or seek approval of transactions as the company's code of ethics required. In two instances, the board waived the conflict-of-interest clause in the ethics code to permit the CFO's dual role, but the waivers themselves raise ethical concerns. Richard C. Breeden, a former chairman of the Securities and Exchange Commission, observed, "The very notion that the chief financial officer of a major corporation would have divided loyalties to this degree of magnitude is something I wouldn't have believed any board of directors would allow—or that any C.F.O. would accept." He added, "The C.F.O. is the financial conscience of the company, the guardian of the numbers. If he has a conflict, how can the system work?"<sup>30</sup>

Enron's public auditing firm, Arthur Andersen, has also been accused of conflict of interest. Although Andersen auditors were troubled by the partnerships—especially whether they were truly independent entities or merely accounting fictions—they apparently did not bring their concerns to the board, as would be expected. One possible reason for this failure is that Andersen also provided consulting services that were far more lucrative than auditing. When an accounting firm occupies such a double role, it has an incentive to ignore accounting irregularities in order to keep a consulting client. Moreover, Andersen auditors performed some of the company's internal bookkeeping, thus blurring the line between conducting an independent audit and managing a company's own financial operations. Auditors who make money keeping a client's books are scarcely independent judges of the integrity of the information they contain.

In creating the partnerships, Enron engaged several major investment banks, which also encountered conflicts of interest. The conflicts here arise when a firm's analysts feel pressure to maintain "buy" recommendations in order

to keep Enron's lucrative deal-structuring business. As a result, many investors maintained confidence in Enron even as the company's troubles were becoming known to its investment advisers. Ironically, the Chinese walls that investment banks build between their analysis and advisory services in order to prevent conflict of interest may have prevented analysts from knowing about Enron's deteriorating condition.

Enron's law firm, Vinson & Elkins, was also accused of a conflict of interest when it was engaged to give a legal opinion after concerns were raised about certain deals in an anonymous letter to the chairman Kenneth Lay. The writer of that letter, Sherron S. Watkins (a whistle-blower who was designated a "Person of the Year" by *Time* magazine), wrote, "Can't use V&E due to conflict—they provided some true sale opinions on some of the deals." Vinson & Elkins was engaged regardless, and the firm gave a clean bill of health to deals they helped develop. In addition, Enron's board of directors was accused of conflict of interest because the company contributed heavily to charities and institutions with which the members were involved and, in one instance, to the political campaign of a member's husband. The suspicion is that the board members' independence was undermined by the generosity of these gifts.

Companies and their employees have an obligation to manage *conflicts of interest* of the kinds illustrated by the Enron case. Virtually all corporate codes of ethics address conflict of interest because it interferes with the ability of employees to act in the best interests of a firm. Accepting gifts or lavish entertainment from suppliers, for example, is generally prohibited or strictly limited for the simple reason that the judgment of employees is apt to be compromised. Company codes usually contain guidelines on investing in customers, suppliers, and competitors of an employee's firm for the same reason.

Prohibitions on conflict of interest cannot be so extensive, however, as to prevent employees from pursuing unrelated business opportunities, taking part in community and political affairs, and generally acting as they see fit in matters outside the scope of their employment. One problem with conflict of interest is in drawing a line between legitimate and illegitimate activities of employees in the pursuit of their personal interests. A further problem is the large grey area that surrounds conflict-of-interest situations. Perhaps no other ethical concept in business is so elusive and subject to dispute. Many people charged with conflict of interest see nothing wrong with their behavior. It is important, therefore, to define the concept clearly, to identify the different kinds of conflicts of interest, and to understand the means available for managing them.

## WRITING PROMPT

### Actual and Potential Conflicts of Interest

Suppose that a good friend of yours is hired to be your direct supervisor at work. This person will now conduct your official performance reviews and determine whether you get raises or promotions, more desirable work assignments, permission for requested days off, and so on. Do you have a responsibility to inform your employer of your friendship with this person? What other actions could you take to prevent the possibility of favoritism? What if you believe your friend is fair-minded enough to treat you the same as your coworkers while on the job?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 5.3.1: Defining Conflict of Interest

The Enron case features numerous individuals and firms with interests that conflict. It would be inaccurate, however, to define a conflict of interest as merely a clash between conflicting or competing interests because these are present in virtually every business relationship. In the relation between buyer and seller, for example, each party strives to advance his or her own interest at the expense of the other, but neither party faces a conflict of interest as the term is commonly understood.

A conflict of interest occurs when a personal interest interferes with a person's ability to promote the interests of another *when the person has an obligation to act in that other person's interest*. This obligation is stronger than the obligation merely to avoid harming a person but involves failing in a duty, and it can arise only when the two persons are in a special relationship, such as employer and employee, which involves some duty. Specifically, the kind of obligation described in this definition is that which characterizes an agency relation in which one person (an agent) agrees to act on behalf of another (the principal) and to be subject to that person's control. This fact explains why conflict of interest is most often encountered by professionals—lawyers, doctors, and accountants, for example—and among fiduciaries, such as executors and trustees. Employees of business firms are also in an agency relation in that they have a general obligation to serve the interests of an employer.

An important feature of an agency relation is its open-endedness. An agent is obligated to perform not merely this or that act but, in the words of the *Second Restatement of Agency*, "to act solely for the benefit of the principal in all matters concerned with his agency."<sup>31</sup> The duties of an agent are not determined solely by a list of moral rules but by the nature of the interests to be served. This open-ended character of the agency relation explains why it is a conflict of interest for an agent to acquire *any* interest that is contrary

to that of a principal, because the kinds of situations in which an agent might be called upon to act in the interest of another are not easily anticipated.

To complete the definition of conflict of interest, some account should also be given of a personal interest. Roughly, a person has an interest in something when the person stands to gain a benefit or an advantage from that thing. "Having an interest" is not the same as "taking an interest." A person can take an interest in someone else's interest, especially when that person is a family member or a close associate. In that case, however, the benefit or advantage accrues to someone else. Furthermore, the benefit or advantage is usually restricted to a financial gain of some kind. Merely satisfying a desire, for example, would not seem to be enough, for otherwise a lawyer who secretly hopes that the client will be convicted would face a conflict of interest, as would a lawyer who prefers to play golf instead of spending the time adequately representing a client. The benefit or advantage would also have to be substantial enough to interfere significantly with a person's performance of an obligation.

## 5.3.2: Some Relevant Distinctions

All instances of conflict of interest are morally suspect, but some are more serious than others. In their rules on conflict of interest, company codes of ethics and codes for professionals, such as lawyers and accountants, contain a number of relevant distinctions that can aid us in understanding the concept of conflict of interest.

### ACTUAL AND POTENTIAL CONFLICT OF INTEREST

There is a distinction between *actual* and *potential* conflicts of interest. A conflict is actual when a personal interest leads a person to act against the interests of an employer or another person whose interests the person is obligated to serve. A situation constitutes a potential conflict of interest when there is the possibility that a person will fail to fulfill an obligation to act in the interests of another, even though the person has not yet done so.<sup>32</sup> A potential rather than an actual conflict of interest is generally at issue in rules that forbid even the *appearance* of a conflict.

Enron's CFO Andrew Fastow was apparently in an actual conflict-of-interest situation, by virtue of having a duty to serve the interests of Enron at the same time when he stood to gain from negotiating favorable terms for the partnerships in which he had a stake. If another person at Enron were bargaining on behalf of the company, then he might have been free to serve the interests of himself and the other partners. However, it appears that he was attempting to serve both interests simultaneously.

Obviously, the categories of actual and potential conflict of interest involve subjective elements. A person of integrity might be able to have a strong personal interest in some

matter and yet still serve the interests of another. Merely having a competing interest creates a potential conflict of interest, but determining whether an actual conflict of interest exists would require us to make a judgment about that person's objectivity. Similarly, whether an interest creates a potential conflict depends on the strength of the influence it exerts on a person. Owning a small amount of stock in a company, for example, is unlikely to influence anyone's conduct, and so most employers do not impose an absolute prohibition on investments. More often they place a dollar limit on outside financial interests, or else they require a disclosure of stock ownership so that the potential for conflict of interest can be evaluated in each case.

**PERSONAL AND IMPERSONAL CONFLICT OF INTEREST** A second distinction can be made between *personal* and *impersonal* conflicts of interest. The definition developed in the preceding section is phrased in terms of a personal interest that comes into conflict with the interests of another. A conflict can also arise when a person is obligated to act in the interests of two different persons or organizations whose interests conflict. Thus, a lawyer who represents two clients with conflicting interests may not stand to gain personally from favoring one or the other, and yet, according to Rule 1.7(a) of the American Bar Association's *Model Rules of Professional Conduct*, such an arrangement constitutes a conflict of interest.<sup>33</sup> A lawyer who has a personal interest that conflicts with the interests of a client has a personal conflict of interest, whereas a lawyer who represents two clients with conflicting interests faces an impersonal conflict of interest.

Insofar as Andrew Fastow stood to gain financially from the partnerships he headed, he faced a personal conflict of interest. However, even if he had no personal stake, there would still be an impersonal conflict of interest if he took an active role in the management of the partnerships. His role as the CFO of Enron commits him to acting in the best interests of the shareholders in all matters, and this duty cannot be fulfilled if he is also committed to serving the interests of the members of the partnerships. For example, deciding whether an unusually profitable investment opportunity should be allocated to Enron or to a partnership would require him to favor one set of interests over the other. This is an instance of the biblical injunction that a person cannot serve two masters.

**INDIVIDUAL AND ORGANIZATIONAL CONFLICT OF INTEREST** Third, conflicts of interest can be either *individual* or *organizational*. In the agency relation, the agent is typically a person acting in the interests of a principal, which may be another person or an organization. However, organizations can be agents as well and hence parties to conflicts of interest. For example, many large accounting firms, like Arthur Andersen, provide management services to companies they also audit, and there is great concern in the profession that this dual function endangers the

independence and objectivity of accountants.<sup>34</sup> Advertising agencies whose clients have competing products face a similar kind of conflict of interest. Investment banking houses have also been accused of conflict of interest for financing takeovers of companies with which they have had long-standing relations. Furthermore, large law firms face the possibility of conflict of interest when they have clients with competing interests—even when the work is done by different lawyers in the firm.

For an accountant to provide management services to a company that he or she also audits—or for an individual ad person, banker, or lawyer to accept clients with conflicting interests—is a clear conflict of interest. But why should it be a conflict when these functions are performed by different persons in different departments of a firm? The answer is that an accounting firm, for example, also has an interest that is shared by every member of the organization, and the interests of the firm can affect decisions about individual clients. Thus, when management services are more lucrative than auditing, firms may have an incentive to concentrate on them to the detriment of other functions. They may also be tempted to conduct audits in ways that favor the clients to whom they provide management services.

Similarly, the creative work for competing advertising accounts is generally done by independent groups, but there is an incentive to commit greater resources and talent to more valuable accounts. In addition, when an organization such as an advertising agency takes on a client, there is an organizational commitment of loyalty that goes beyond merely delivering agreed-upon services. For an organization to work for and against a client at the same time is incompatible with this kind of organizational commitment. Advertising campaigns also involve sensitive information about product development and marketing strategies that is not easily kept confidential. Investment banks and large law firms encounter similar challenges to their ability to serve the interests of all clients to the fullest.

### 5.3.3: Kinds of Conflict of Interest

The concept of conflict of interest is complex in that it covers several distinct moral failings that often run together. It is important to separate them, though, in order to have a full understanding both of the definition of conflict of interest and of the reasons that it is morally wrong for a person to be in a conflict-of-interest situation.

Briefly, there are four kinds of conflicts of interest:

1. exercising biased judgment,
2. engaging in direct competition,
3. misusing a position, and
4. violating confidentiality.

Each of these calls for some explanation.

**BIASED JUDGMENT** The exercise of judgment is characteristic of professionals, such as lawyers, accountants, and engineers, whose stock in trade is a body of specialized knowledge that is used in the service of clients. Not only are professionals paid for using this knowledge to make judgments for the benefit of others but also part of the value of their services lies in the confidence that can be placed in a professional's judgment. Accountants do not merely examine a company's financial statements, for example; they also attest to the accuracy of those statements and to their compliance with generally accepted accounting principles, or GAAP. The National Society of Professional Engineers' *Code of Ethics for Engineers* stipulates that engineers shall not submit plans or specifications that are unsafe or not in conformity with accepted engineering standards.<sup>35</sup> So an engineer's signature on a blueprint is also a warrant of its quality.

Judgment is not exclusively a feature of professional work. Most employees are called upon to exercise some judgment in the performance of their jobs. Purchasing agents, for example, often have considerable latitude in choosing among various suppliers of a given product. The judgment of purchasing agents in all matters, however, should be used to make decisions that are in the best interests of the employing firm. For a purchasing agent to accept a bribe or kickback in return for placing an order constitutes a clear conflict of interest. The reason is simple. Bribes and kickbacks are usually intended to induce an employee to grant some favor for a supplier at the expense of the employer. Other factors that could influence the judgment of an employee include outside business interests, such as an investment in a competitor or a supplier, or dealings with businesses owned by family members.

### Are gifts considered bribes?

#### It depends

Whether it is a potential conflict of interest for a purchasing agent to accept a gift from a supplier who expects favorable treatment in the future is less clear. An answer to this question depends largely on the value of the gift, the circumstances under which it is offered, the practice within the industry, and whether the gift violates any law. The code of ethics of a large bank, for example, states that employees should not accept gifts where the purpose is "to exert influence in connection with a transaction either before or after that transaction is discussed or consummated. Gifts, for any other purpose, should be limited to those of nominal value." "Gifts of nominal value," the code continues, "generally should be limited to standard advertising items displaying a supplier's logo." A maximum value of \$25 is suggested as a guideline.

**DIRECT COMPETITION** For an employee to engage in direct competition with his or her employer is often, but

not always, a conflict of interest. An obvious source of conflict is that an employee's judgment might be impaired merely by having another interest, in this case the interest in performing other work and, presumably, receiving additional compensation. In addition to impaired or biased judgment, the quality of an employee's work might be reduced by the time and effort devoted to other activities. Direct competition is generally prohibited by companies, though, even when there is no danger of impaired judgment or diminished work performance, since the success of a direct competitor is likely to come at the expense of the employer in question. Put bluntly, direct competitors limit a company's profitability. Competing businesses cannot be avoided, but profit-limiting competition should not come from a company's own employees.

An employee's duty not to compete with an employer can be justified without invoking the concept of conflict of interest. The duty of loyalty that binds employees as agents of an employer would ordinarily be sufficient to preclude direct competition, and some employees also sign a noncompete agreement, which is a contractual device for prohibiting direct competition both before and for some period after the current period of employment. A duty of noncompetition gains added support, though, by being recognized as a conflict of interest. However, both a duty of loyalty and a duty to avoid conflict of interest have limits and are not so strong as to prohibit all competing employment.

### What if the amount of competition is negligible?

#### Examples

Consider the case of a plumber, employed by a plumbing company, who does work on the side for friends and neighbors, or of a lawyer in a firm who provides after-hours volunteer legal services for a nonprofit organization. Such activity is unlikely to affect an employee's judgment or performance—although it would be morally objectionable if it did have such an effect. The employer's interest in each case is impacted, though, if the "side" business would otherwise go to the plumbing company or the law firm. Even if it would have this impact, however, a conflict of interest would occur only if the plumber or the lawyer had a duty to bring such business to the employer. The justification of such a duty is arguably stronger for the lawyer than for the plumber, but such cases can be resolved easily merely by disclosing the outside work to the employer and by receiving the employer's approval, which should not be unreasonably denied.

**MISUSE OF POSITION** Misuse of position constitutes a third kind of conflict of interest. In April 1984, a reporter for the *Wall Street Journal* was fired for violating the newspaper's policy on conflict of interest. The firing occurred

after R. Foster Winans, a contributor to the influential stock market column “Heard on the Street,” admitted to his employer and investigators from the Securities and Exchange Commission that he conspired over a four-month period, beginning in October 1983, with two stockbrokers at Kidder, Peabody, & Company to trade on the basis of advance information about the content of the column. One of the charges against R. Foster Winans was that he misused his position as a *Wall Street Journal* reporter to enrich himself in violation of a provision in the newspaper’s code of ethics.<sup>36</sup>

Consider the hypothetical case of a bank manager who, in the course of arranging home improvement loans, makes it a point to ask customers whether they have lined up a contractor. She casually drops the name of her brother who operates a general contracting business and mentions that a number of bank customers have been very satisfied with the work of his company. The bank manager’s mention of her brother is clearly improper if she misuses her power to grant or deny a loan to induce customers to use him as a contractor. A conflict of interest is still present, though, even if she does not allow her personal interest to have any effect on the decisions she makes on behalf of her employer. There is no conflict between the interests of the manager and those of the bank, and the bank is not harmed in any significant way. Still, the manager has taken the opportunity to advance her personal interests while acting in her capacity as an official of the bank. Holding a position with a company or other organization gives a person powers and opportunities that would not be available otherwise, and an employee has an obligation not to use these powers and opportunities for personal gain.

Extortion also constitutes a misuse of position. Unlike bribery, with which it is often confused, extortion does not involve the use of a payment of some kind to influence the judgment of an employee. Rather, extortion in a business setting occurs when a person with decision-making power for a company demands a payment from another party as a condition for making a decision favorable to that party. For example, a purchasing agent who threatens a supplier with a loss of business unless the supplier agrees to give a kickback to the purchasing agent is engaging in extortion. Extorting money from a supplier in this way is a conflict of interest, even if the company is not directly harmed, because the purchasing agent is violating an obligation to act in the position solely for the interests of the employer.

**VIOLATION OF CONFIDENTIALITY** Finally, violating confidentiality constitutes, under certain circumstances, a conflict of interest. The duty of lawyers, accountants, and other professionals, for example, precludes the use of

information acquired in confidence from a client to advance personal interests—even if the interests of the client are unaffected. Similarly, because a director of a company is privy to much information, it would be wrong to use it for personal gain or other business interests.

The case of R. Foster Winans also illustrates a conflict of interest involving a breach of confidentiality.

### Case: R. Foster Winans

A reporter with information prior to publication who attempts to capitalize on the expected results is using that information for his or her own personal gain. Specifically, the courts found Mr. Winans guilty of misappropriating confidential information that properly belonged to his employer. In the Supreme Court decision affirming the conviction of Mr. Winans, Justice Byron White observed,

Confidential business information has long been recognized as property. “Confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit.”<sup>37</sup>

Justice White further noted,

The District Court found, and the Court of Appeals agreed, that Winans had knowingly breached a duty of confidentiality by misappropriating prepublication information regarding the timing and the contents of the “Heard” column, information that had been gained in the course of his employment under the understanding that it would not be revealed in advance of publication and that if it were, he would report it to his employer.

## WRITING PROMPT

### Kinds of Conflicts

Which kind of conflict of interest do you think is most common in the workplace? Identify any conflicts that strike you as being more unethical than the others, or more difficult to identify or prove. Explain your reasoning.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 5.3.4: Managing Conflict of Interest

Conflict of interest is not merely a matter of personal ethics. A person in a conflict of interest, either potential or actual, may be in the wrong, but conflicts usually occur in the course of being a professional or a member of an organization. Often, these conflicts result from structural features of a profession or an organization and must be managed through carefully designed systems.

Professions, such as medicine, law, and accounting, are highly vulnerable to conflict of interest because of their strong duty to serve the interests of others as patients or

clients. Business firms in particular industries also face conflicts because of their need to provide many different kinds of services to many different clients or customers. In some cases, both professional and organizational factors are involved.

**Example:** Accountants sometimes own stock in the companies that they audit, and the firm they work for may also provide consulting services to its auditing clients. Obviously, accounting firms need to employ a variety of means for managing these kinds of conflicts of interest.

Fortunately, there are many means for managing conflict of interest. Most corporations have a section in their code of ethics that specifically addresses the problem. In some industries, especially financial services, companies have comprehensive compliance programs for ensuring the utmost integrity.

**Example:** An obvious conflict of interest exists when the portfolio manager of a mutual fund also engages in personal trading for his or her own account. Securities and Exchange Commission Rule 17j-1 requires mutual fund companies to develop policies and procedures to prevent inappropriate personal investing. In response, companies have adopted very extensive systems that prohibit certain kinds of trades (e.g., short-selling), require pre-clearance of other trades, and ban participation in initial public offerings (IPOs). In addition, mutual funds closely monitor portfolio managers and prepare periodic reports of violations.

As these examples indicate, the management of conflict of interest requires a variety of approaches. The following is a list of the major means by which professional groups and business organizations can manage conflicts of interest: objectivity, avoidance, disclosure, competition, rules and policies, independent judgment, and structural changes.

### 1. Objectivity

A commitment to be objective serves to avoid being biased by an interest that might interfere with a person's ability to serve another. Virtually all professional codes require objectivity. Indeed, the code for certified public accountants, which requires objectivity and independence, identifies objectivity (the obligation to be impartial and intellectually honest) with avoiding actual conflicts of interest, and independence (avoiding relations that would impair objectivity) with potential conflicts.

### 2. Avoidance

The most direct means of managing conflicts of interest is to avoid acquiring any interests that would bias one's judgment or otherwise interfere with serving others. Avoidance is easier said than done, however.

There are two main complications.

- First, it may be difficult to anticipate or identify a conflicting interest.

**Example:** Law firms typically conduct a review of new clients to avoid conflicts of interest, but when the numbers of relations on both sides are numerous, such a review may miss some potentially conflicting interests.

- Second, acquiring conflicting interests may be unavoidable due to the nature of the business. This is especially true of investment banking, where conflicts of interest are built into their structure.

**Example:** A large investment bank routinely advises clients on deals that affect other companies which the bank also advises or whose securities the bank holds. Investment banks have been accused of modifying research reports on stocks in order to avoid antagonizing companies from which they solicit business. As one person notes, "The biblical observation that no man can serve two masters, if strictly followed, would make many of Wall Street's present activities impossible."<sup>38</sup>

Where adverse interests cannot be avoided, they can be countered by introducing new interests in a process known as *alignment*. For example, a problem in corporate governance is that CEOs, who are supposed to serve the interests of shareholders, have personal interests that often interfere. One solution is the use of pay-for-performance measures, such as stock options, that *align* the CEO's personal interest with that of shareholders.

**Another example:** Stockbrokers are in a conflict-of-interest situation when their compensation is tied to the number of trades that a customer makes and not to the quality of these trades. The solution in this case is to base the broker's compensation on the customer's portfolio return, thus aligning the broker's interest more closely to the client's.

### 3. Disclosure

Disclosure serves to manage conflict of interest primarily because whoever is potentially harmed by the conflict has the opportunity to disengage or at least to be on guard. For example, a stockbroker who is paid more to sell a firm's in-house mutual funds faces a conflict of interest in recommending a fund to a client. A client who knows of the potential bias can seek out another broker who is uninfluenced by the difference in compensation or can evaluate more carefully the broker's advice to detect any bias. In short, forewarned is forearmed.

In legal ethics, a conflict of interest is permissible if the following three conditions are satisfied.

- The lawyer discloses the conflict to the client,



- the lawyer is confident that he or she can provide wholly adequate representation so that the client will be unaffected by the conflict, and
- the client accepts the lawyer's service under those conditions.<sup>39</sup>

In addition to adverse interests, disclosure may include all kinds of information. The greater the transparency—that is, openness of information—the less opportunity there is for conflict of interest to occur. For example, conflict of interest in government is managed in part by requiring officials to disclose financial holdings, but disclosure in the press of officials' activities also reduces conflicts. Thus, we are better able to judge whether a legislator has a conflict of interest if we know not only how much stock he or she owns in a company affected by a bill but also how that person voted on the bill.

#### 4. Competition

Strong competition provides a powerful incentive to avoid conflicts of interest, both actual and potential. For example, at one time commercial banks gave their brokerage business to firms that were already bank customers. This practice, known as reciprocity or "recip," has virtually disappeared because of the need for returns on trust accounts to compare favorably with alternative investments. Competition dictates that the allocation of brokerage commissions be based on the "best execution" of trades and not on keeping bank customers happy. Of course, no firm would use increased competition as a means for managing conflict of interest, but industry regulators should recognize that the power of competition to reduce conflict of interest is another reason to encourage competition.

#### 5. Rules and Policies

As already noted, most companies have policies concerning conflicts of interest. These typically require employees to avoid acquiring adverse interests by not accepting gifts or investing in potential suppliers, for example. Rules and policies may also prohibit the kind of conduct that would constitute a conflict, as when a broker trades ahead of a large customer, a practice known as "frontrunning." Conflict of interest may be managed by other rules and policies that do not address conflict of interest directly and have other purposes. For example, controls on the flow of information that affect who has access to what information are necessary for many reasons, but the rules and policies in question also limit conflict of interest. Thus, a portfolio manager of a particular mutual fund who has no knowledge of pending purchases by other funds in the firm has fewer possibilities for conflict.

Priority rules are an especially useful means for managing conflict of interest. For example, an investment bank that advises outside investment funds faces a conflict of interest in deciding which investment opportunities to bring to each fund. This problem is especially acute if the bank also operates its own in-house funds. Generally, in such cases, the

bank establishes priority rules so that each client knows the order of favor. A client who knows in advance that the better opportunities will be allocated to other funds cannot complain of unfair treatment.

#### 6. Independent Judgment

Insofar as a conflict of interest results in biased judgment, the problem can be corrected by utilizing a third party who is more independent. In courts of law, a judge who, say, owns stock in a company affected by a case is generally obligated to *recuse* himself or herself and allow the decision to be rendered by other judges. Companies usually require an executive with a conflicting interest to pass the decision to the next level. Independent appraisers are often utilized in cases where an insider, such as an executive or a director, is engaging in a property transaction with a corporation. In firms with frequent conflict-of-interest problems, such as investment banks, in which the conflict exists among various units, a standing independent advisory board is often formed to consider matters referred to it.

#### 7. Structural Changes

Because conflicts of interest result from providing many different services to different customers or clients, they can be reduced by compartmentalizing these services. Advertising agencies, for example, form separate creative teams for each account; accounting firms separate auditing and advisory services; and commercial banks split trust management from the retail side of the business. Within multifunction institutions, conflicts can be reduced by strengthening the independence and integrity of each unit. For example, instead of treating the investment research division as an arm of their brokerage units, investment banks are being urged to upgrade their status and insulate them from pressure.

Some structural features of American business are dictated by law. Because of the potential conflicts of interest, Congress mandated that commercial banks could not also sell stocks or insurance, thereby making investment banking and insurance separate businesses. Pressure is building among federal regulators to force accounting firms to form separate auditing and consulting companies. Addressing the problem of conflict of interest by structural changes is probably unwise overall, however, because of the many advantages of combining different services in one firm. Separating the functions of an investment bank, for example, might reduce conflicts of interest, but a firm that underwrites corporate securities needs the sales capacity of its brokerage unit and the skills of its research department. On the whole, we probably gain much more than we lose by having firms that provide multiple services.

To review these recommended techniques for managing conflict of interest, consider the following scenario.

## Simulation: Managing Conflicts of Interest

Many financial planners employed by financial services firms or banks provide one-on-one advice to clients about how to best meet their financial goals. Such planners also sell products, such as investment funds and life insurance, to meet their client's needs. Financial planners often receive higher sales commissions for selling "in house" products to their clients. "In house" products are developed and sold by the same firms that employ the planner. The concern voiced by many observers is that financial planners should be providing impartial recommendations to clients and the "in house" commissions may provide an incentive for planners to recommend certain products that aren't objectively in the best interest of the client.

How could financial planners begin to deal with the conflict of interest that such sales practices create?

The planner could adopt a commitment to be objective, to avoid being biased by an interest that might interfere with his or her ability to serve clients.

Virtually all professionals are obligated to be impartial and intellectually honest, including financial planners. Even if planners strive to avoid bias their judgment, however, financial services firms and banks may need to take steps to better align the interests of planners with the interests of their clients.

Another option is to remove the risk of biased judgment by utilizing a third party who is more independent. Supervisors or other management officials who are not paid on commissions, or who are evaluated on criteria not related to "in house" sales, could periodically review how well client's interests are being met.

The planner could make the commission structure known to clients, so they have the opportunity to disengage or at least to be on guard.

Being more open with information reduces the opportunity for financial planners to recommend products that are not in the client's interest. If one planner discloses information about commissions, it is also possible that others at the same firm or other firms will then feel pressured to do the same.

Strong competition between financial planning firms also provides a powerful incentive to avoid conflicts of interest, both actual and potential. In the financial services industry, firms which have a reputation for conflicts or which tolerate conflicts of interest will be less successful than their more scrupulous rivals.

What can financial planning and investment firms do to help prevent the conflicts of interest that arise from selling financial products (including their own in-house products)?

Because conflicts of interest result from providing many different services to different customers or clients, they can be reduced by compartmentalizing these services.

Most companies have policies that require employees to avoid acquiring conflicting interests.

Preventative measures that can be taken by a firm include making the firm's sales and planning units independent, to help insulate them from pressure by the others. Financial services firms and banks also could require disclosure of commissions to clients, eliminate higher commissions for "in house" products, provide opportunities for clients to seek review of their planner's work, and disclose internal priority rules to clients.

Lastly, laws could be adopted to require financial planners or other advisors to be recognized as fiduciaries.

### WRITING PROMPT

#### A Standard Practice

Taking precautions against conflicts of interest is standard practice in the business world. But how would you explain the necessity of anticipating and managing potential conflicts to someone who saw no need to take such precautions? Describe an example situation and possible solution.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## Conclusion: Business Information and Conflict of Interest

The ethical issues in both business information and conflict of interest involve a delicate balancing of the rights and interests of employers and employees, as well as the public at large. Especially in the case of confidential and proprietary information, we see how different kinds of arguments—about duties, rights, and fairness—underlie the law in this area and support our views about what is morally right. For the most part, the language of duties and rights has dominated the discussion, although harms and benefits are also important factors. Conflict of interest also involves the concept of duty, specifically the duty of agents, fiduciaries, and the like to serve the interest of others—and the personal interests that interfere in the ability of people with this duty to act accordingly.

### End-of-Chapter Case Studies

This chapter concludes with three case studies.

In “The Aggressive Ad Agency” and “Procter & Gamble Goes Dumpster Diving,” corporate executives consider how to handle offers of other companies’ confidential or proprietary information that may be “too hot to handle.” In both cases, the executives recognize the inappropriateness of accepting the information, but difficulties remain for each one in deciding how to refuse the offered information ethically. The “conflict-laden deal” handled by Goldman Sachs, for which the investment giant was heavily criticized at the time, is a useful illustration of how multiple conflicts may be incurred by the different parties in complex transactions and why policies on conflict of interest are so difficult to design and enforce.

### Case: The Aggressive Ad Agency

Rob Lebow was used to aggressive advertising agencies. As director of corporate communications for Microsoft Corporation, the giant computer software producer located in Redmond, Washington, Lebow helped to administer the company’s \$10 million advertising budget. So when it was announced in the fall of 1987 that Microsoft was conducting an agency review, putting its business up for grabs, he was prepared for a flood of calls and letters. One particular piece of mail that caught his eye was a specially prepared flier from a small agency in Boston named Rossin Greenberg Seronick & Hill (RGS&H).

Under the leadership of its president, Neal Hill, this five-year-old advertising agency had accounts totaling \$26 million and a growth rate of 65 percent for the past year. Although its business was concentrated in New England, RGS&H was attempting to become a national force by going after high-tech industries. As part of this strategy, the agency recruited two talented people who had worked on an account for the Lotus Corporation at another firm. Jamie Mambro and Jay Williams, who were creative supervisors at Leonard Monahan Saabye in Providence, Rhode Island, joined RGS&H on November 2.

A few days later, Neal Hill read a news story in a trade publication about the agency review by the Lotus rival. Because Microsoft’s new spreadsheet program, Excel, was competing directly against Lotus 1-2-3, the industry leader, this seemed to be an ideal opportunity for RGS&H.

The flier was sent by Neal Hill on November 20, after two previous letters and several telephone calls elicited no response from Microsoft. Included in the flier was a round-trip airline ticket from Seattle to Boston and an invitation that read in part:

You probably haven’t thought about talking to an agency in Boston. . . . But, since we know your competition’s plans, isn’t it worth taking a flier? . . . You see, the reason we know so much about Lotus is that some of our newest employees just spent the past year and a half working on the Lotus business at another agency. So they are intimately acquainted with Lotus’ thoughts about Microsoft—and their plans to deal with the introduction of Excel.

In order to do an effective job for a client, advertising agencies must be provided with a certain amount of confidential information that would be of value to competitors. Many companies include a confidentiality clause in their contracts with advertising agencies, and Lotus had such an agreement with its agency, Leonard Monahan Saabye. Even in the absence of a confidentiality clause, however, advertising agencies generally recognize an obligation to preserve the confidentiality of sensitive information.

On the other hand, offering the experience of employees who have handled similar accounts is an accepted practice in the advertising industry. As the president of one firm observed, “There’s a thin line between experience and firsthand recent knowledge.” But, he continued, “I can’t imagine a new-business presentation in which the agency didn’t introduce people who worked on the prospect’s kind of business.”<sup>40</sup>

Rob Lebow was left to wonder: Was Neal Hill at RGS&H offering Microsoft the experience of two employees who had worked on the Lotus account, or was he

offering to sell confidential information? In either event, what should Lebow do?

If the new employees at RGS&H had information about Lotus's advertising strategy for countering the introduction of Excel, this could be of considerable value to Microsoft. Anticipating the moves of rivals is often critical to the success of a campaign. However, moving even a part of Microsoft's business to another agency—especially to a small, untested agency like RGS&H—would surely attract the attention of Lotus. In the rumor-filled world of advertising, the presence of two employees who had formerly worked on a Lotus account would not go unnoticed. Therefore, any information that RGS&H had might be “too hot to touch.”

Rob Lebow recognized that he could decline the offer in different ways. He could merely ignore the flier, or he could return it with the reply “Thanks but no thanks.” Another possibility was to forward the flier to Lotus. Even the rumor that Microsoft had communicated with RGS&H could be damaging to the company, and so being open with Lotus would provide some protection. However, Lotus has a reputation within the industry of being quick to sue, and considerable harm could be done to RGS&H—and to the two new employees, Jamie Mambro and Jay Williams, who might be unaware of the offer made in the flier.

Thus, any decision that Rob Lebow made was bound to have significant ethical, legal, and practical implications.

#### SHARED WRITING: THE AGGRESSIVE AD AGENCY

What kind of business information is the agency offering to Microsoft, and why might it be unethical for Rob LeBow to accept the offer? Explain what you would advise Rob LeBow to do in this situation. What are his options, and how would each one affect Microsoft's interests? Describe any common interests between Microsoft and Lotus that Rob should seek to protect.

Review and comment on at least two classmates' responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Procter & Gamble Goes Dumpster Diving

According to *Competitive Intelligence Magazine*, John Pepper, the chairman of Procter & Gamble, told a group that competitive intelligence was “of singular importance” to a consumer products company and that P&G had shifted “from collecting, analyzing and disseminating information, to acquiring and using knowledge to create winning strategies.”<sup>41</sup> Despite these strong words, Mr. Pepper was apparently alarmed to hear that competitive intelligence sleuths

hired by P&G had obtained approximately 80 confidential documents from its European-based rival Unilever through questionable means. One or more persons had sorted through the trash bins at Unilever's downtown Chicago office in a practice known as “dumpster diving.” After learning how P&G's competitor intelligence had been obtained, Mr. Pepper informed Unilever of the misdeeds and personally called the Unilever chairman to settle the matter.

In the highly competitive business of shampoo and other hair-care products, information about new product lines, launch dates, pricing, advertising plans, and production figures is carefully guarded. Like many companies, P&G attempts to gather all publicly available information about its competitors' activities for what the company calls “competitive analysis.” Competitive-analysis executives at P&G had contracted with an outside firm, which in turn hired several subcontractors to investigate competitors. A budget estimated at \$3 million was allotted to the competitor intelligence gathering project, which began in the fall of 2000. The operation was run out of a safe house, called “The Ranch,” located in P&G's home town of Cincinnati, Ohio. Among the secrets gained from dumpster diving at Unilever's Chicago office were detailed plans for a product launch in February and figures for prices and profit margins. In addition to dumpster diving, which P&G admitted, Unilever believed that some rogue operators also misrepresented themselves to competitors as market researchers and journalists in efforts to elicit information, a charge that P&G denied.

Although P&G claims that nothing illegal was done—the law in such cases is quite murky—the dumpster diving violated the company's own code of ethics and its policies for competitive intelligence contractors. The ethics code of the Society of Competitive Intelligence Professionals also prohibits dumpster diving when the bins are on private property, in which case laws against trespassing are likely to be violated. In April 2001, when the company became aware that the spying operation had spun out of control, three executives overseeing the project were fired. Mr. Pepper then contacted Unilever with full disclosure and a promise not to use any of the information gained. P&G had, in effect, blown the whistle on itself. Mr. Pepper hoped perhaps that this gesture would put the matter to rest. However, Unilever had just begun to seek a settlement.

In the ensuing negotiations, Unilever proposed that P&G compensate Unilever between \$10 million and \$20 million for possible losses incurred from the unethical acquisition of information. In addition, Unilever wanted P&G to reassign key personnel in its hair-care division who had read the documents to other positions in which they could not utilize the information they had gained. Perhaps the most unusual remedy was that P&G allow an independent third party to investigate the company's hair-care business for several years and to report to Unilever any

situations in which improperly gained information might have been used. Unilever suggested that if a satisfactory settlement could not be reached, then the company might sue in court, with uncertain results.

If John Pepper thought that notifying Unilever and firing the people involved were the right things to do, then Unilever's proposals might seem to be an unwarranted punishment that would discourage others from being so forthright. On the other hand, aside from any monetary payment, P&G could continue to compete as vigorously as it would have had it not gained the information from dumpster diving. A settlement on Unilever's terms might effectively restore fair competition.

On August 28, 2001, Mr. Pepper flew to London for final negotiations, knowing that he would soon have to make a decision. By September 6, an agreement had been reached. The terms were not disclosed, but Mr. Pepper affirmed in a statement, "This agreement will have no impact on the effectiveness of our product or marketing plans and will not inhibit fair and vigorous competition in the marketplace." A subsequent 2005 company brochure *Our Values and Policies* affirmed, "We collect competitive information through proper public or other lawful channels but do not use information that was obtained illegally or improperly by others, including through misrepresentation, invasion of property or privacy, or coercion."

#### SHARED WRITING: PROCTER & GAMBLE GOES DUMPSTER DIVING

Comment on the actions of all involved parties. To what extent was P&G responsible for the actions of the intelligence-gathering firm it had hired? Did John Pepper have a moral obligation to inform Unilever of the situation, or would it have been morally sufficient to handle the situation internally? For what reasons could Unilever's response be considered ethical?

Review and comment on at least two classmates' responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: A Conflict-Laden Deal

When El Paso Corporation was considering the spin-off of its oil and gas exploration and production unit, the company's board turned to its longtime financial advisor, Goldman Sachs.<sup>42</sup> The leader of the Goldman team was an experienced oil and gas banker, Steve Daniel. The investment bank had valued El Paso's exploration and production (E&P) unit between \$6 billion and \$10 billion, and a successful sale would earn Goldman a \$25 million fee.

When El Paso announced its interest in the spin-off, an unsolicited, nonpublic offer was made by Kinder Morgan on

August 30, 2011, for the purchase of the whole company. Kinder Morgan, a privately owned oil and gas pipeline and storage company based in Houston, Texas, was interested only in El Paso's pipelines, but it was willing to buy the whole company and sell the E&P unit to finance the deal. The Kinder Morgan offer of \$25.50 per share was quickly rejected by the El Paso board as inadequate, but a more realistic, higher offer was surely forthcoming since Kinder Morgan was anxious to complete a deal before El Paso proceeded to split up the company or another suitor entered into the bidding. Although publicly soliciting bids might have been in El Paso's best interest, the board continued private negotiations with Kinder Morgan.

## The Conflicted Parties

Goldman Sachs now found itself in a conflict of interest because it held a 19 percent stake in Kinder Morgan worth \$4 billion and controlled two seats on the company's board of directors. The value of Goldman's stake in Kinder Morgan would be enhanced by the purchase; and the lower the price for El Paso, the better. This obvious conflict was disclosed to the El Paso board, which decided to keep Goldman as a financial advisor, but the board also accepted Goldman's recommendation to engage a second investment bank for a more independent judgment, free of conflicts. The firm Morgan Stanley was chosen for this role. Goldman Sachs did not disclose—indeed, the firm may not have known at the time—that the lead banker, Steve Daniel, personally had a \$340,000 investment in Kinder Morgan. Mr. Daniel kept this information to himself.

The El Paso board appointed the company's CEO Doug Foshee to conduct the negotiations with Rich Kinder of Kinder Morgan for the sale of the whole company. A price of \$28 per share was sought by the board, and by September 22, Mr. Foshee had completed the paperwork for a sale at \$27.55 subject to a due diligence study. The next day, on September 23, Kinder Morgan suddenly announced that the analyst projections it had relied on were too optimistic and that the company would not honor its commitment at the agreed-upon price. Mr. Foshee lowered his expectations and ultimately settled for a price of \$26.87 per share for a deal value of \$21.1 billion. Both Goldman Sachs and Morgan Stanley, relying on their own analyses, advised the El Paso board to accept the deal. The acquisition agreement was signed on October 16, 2011, and contained provisions for sanctions that effectively prevented El Paso from accepting any better offer.

Morgan Stanley, it turned out, was not free of conflicts. The contract with El Paso specified that the fee of \$35 million would be paid to Morgan Stanley only if the whole of El Paso was sold to Morgan Kinder. If the whole company or only the E&P unit were sold to any other buyer, no matter the price, Morgan Stanley would receive nothing. Giving unbiased advice under those conditions would have required an extraordinary commitment to objectivity.

Goldman Sachs was in the comfortable position that it would receive a \$20 million fee if the whole of El Paso were sold to Kinder Morgan or \$25 million if only the E&P unit were sold to any buyer. The \$5 million difference in fees from a sale of El Paso to Kinder Morgan would be more than offset by the increase in the value to Goldman's stake in Kinder Morgan. Goldman would still be able to collect the \$25 million fee if, as occurred, the E&P unit were eventually sold. As one writer observed, "Goldman guaranteed its payday."<sup>43</sup>

## The Shareholders' Response

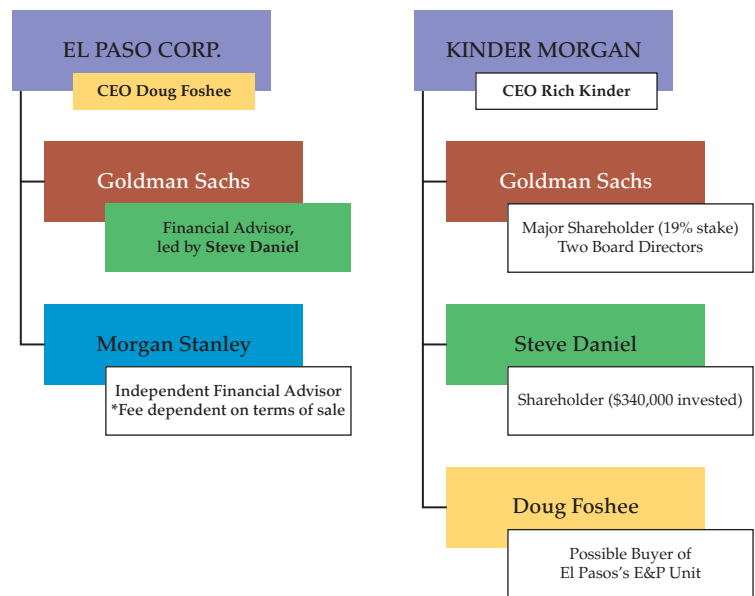
The shareholders of El Paso had good reason to favor the merger. Although the price that Doug Foshee had negotiated with Kinder Morgan was perhaps not the highest possible, it was still 37 percent above the price of El Paso stock on the day before the agreement was announced. Furthermore, no other bidders had appeared; it was this deal or nothing. A higher offer might also have been obtained by seeking other buyers more actively and resisting more aggressively when Kinder Morgan reneged on its initial commitment.

El Paso shareholders were shocked to learn, however, that CEO Doug Foshee, who had conducted the negotiations alone, without board oversight or outside counsel, also had a conflict of interest. During the negotiations, he was planning with a few other El Paso executives to buy the E&P unit from Kinder Morgan after the merger. At no time, did Mr. Foshee disclose this intention to the board or other participants in the negotiation. Thus, although his role as CEO of El Paso was to obtain the highest price possible for the shareholders, he had a hidden incentive to ensure completion of the sale of the company to Kinder Morgan at any price. A cheap price, moreover, might ingratiate him with Kinder Morgan and also, possibly, lower the purchase price of the E&P unit. After the signing of the agreement with Kinder Morgan, Mr. Foshee approached Rich Kinder twice about a management buyout of the E&P unit.

Some outraged El Paso shareholders petitioned a court to prevent the scheduled shareholder vote in view of the extensive conflicts of interest (see Figure 5.3). Although the conflicts of Goldman Sachs and Morgan Stanley were known by all parties and addressed to the satisfaction of the El Paso board, the undisclosed conflicts of two key individuals, Steve Daniel and Doug Foshee, appeared to taint the negotiations.

The judge in the case was also troubled by the web of conflicts but declined to block a shareholder vote, arguing that the shareholders themselves should be allowed to decide, in light of this new information, whether to proceed with the merger. In addition, there were no other competing bids to consider. On March 9, 2012, 95 percent of El Paso shareholders approved the merger. Two weeks previously, an agreement was reached to sell the E&P unit for \$7.15 billion

**Figure 5.3** Key Players in the Sale of El Paso Corp. to Kinder Morgan



to two investment groups in which the role of El Paso executives, including Mr. Foshee, was uncertain.

Although dissatisfied shareholders were not able to prevent a vote, they could still sue after the merger to recover any loss they suffered from the conflicts of interest. This amount would be the difference between the actual price they received for their shares and the price that might have been obtained from an agreement made by less conflicted parties. In December 2012, a court ordered that the shareholders be compensated \$110 million plus an award of \$26 million for their legal costs. Goldman Sachs contributed \$20 million to the settlement by forgoing its fees for advisory services in the merger. Prior to its involvement in this merger, in January 2011, Goldman revised its *Business Standards* to include this declaration: "Conflicts of interest and the firm's approach to dealing with them are fundamental to our client relationships, our reputation and our long-term success."

### SHARED WRITING: A CONFLICT-LADEN DEAL

Which conflict of interest would you expect to have the greatest influence on this deal? If you could change one aspect of the deal to help ensure that it was in the best interests of El Paso's shareholders—making the subsequent lawsuit unnecessary—what would you change, and why?

Review and comment on at least two classmates' responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

# Chapter 6

# Privacy



## Learning Objectives

- 6.1** Identify how different business practices challenge the privacy of employees in the workplace and consumers in the marketplace
- 6.2** Explain the concept of privacy and how utilitarian and Kantian arguments can be used to defend a right to privacy
- 6.3** Evaluate the reasoning that leads a company to monitor its employees and the measures undertaken to limit such monitoring
- 6.4** Determine what ethical issue(s) are associated with a particular handling or use of employee records and whether the action is justified or a violation of the employee's privacy
- 6.5** Describe how big data analytics enables companies to profile and target consumers and the potential ethical issues with this process
- 6.6** Analyze the ethical issues associated with collecting and using information about consumers' online activities, and the adequacy of the rules and principles created to protect Internet privacy

## Case: Psychological Testing at Dayton Hudson

In April 1989, Sibi Soroka answered the following questions satisfactorily and was hired as a Store Security Officer (SSO) at a Target store in California.

*Answer each of the following questions True or False:*

*I feel sure there is only one true religion.*

*My soul sometimes leaves my body.*

*I believe in the second coming of Christ.*

*I wish I were not bothered by thoughts about sex.*

*I am very strongly attracted by members of my own sex.*

*I have never indulged in any unusual sex practices.*

After this application process, Soroka felt "humiliated" and "embarrassed" at having to reveal his "innermost beliefs and feelings." So he joined with two rejected job applicants in a class-action suit, charging the Dayton Hudson Corporation, the owner of the Target store chain, with invasion of privacy.<sup>1</sup>

Psychological testing is one of many means for enabling employers to evaluate applicants and select the best employee

for a job. In the 1920s, the owner of Frank Dry Goods Company in Fort Wayne, Indiana, noticed that some salesgirls sold two to four times as much merchandise as others.<sup>2</sup> Further investigation revealed that the top sellers came from large working-class families with savings accounts, whereas the low performers were from small families that did not need the money and were opposed to the employment. Accordingly, the company developed a set of test questions for job applicants that asked about family size, the occupations of family members, the amount of income needed for an average family, the attitude of the family about working in the store, and the existence of savings accounts.

Dayton Hudson defended the use of the psychological test, called Psychscreen, on the grounds that an SSO, whose main function is to apprehend suspected shoplifters, needs good judgment, emotional stability, and a willingness to take direction. Psychscreen is a combination of two standard tests that have been administered to applicants for such public safety positions as police officers, prison guards, air traffic controllers, and nuclear power-plant operators. The completed Psychscreen test is interpreted by a firm of consulting psychologists, which rates an applicant on five traits (emotional stability, interpersonal style, addiction potential, dependability, and rule-following behavior) and offers a recommendation on whether to hire the applicant. Dayton Hudson does not receive the answers to any specific questions.

Dayton Hudson admitted in court that it had not conducted any studies to show that Psychscreen was a reliable predictor of performance as a security officer, except to administer the test to 18 of its most successful SSOs. The company could not document any improvement in the performance of SSOs after adopting the test or any reduction in shoplifting. An expert witness for the plaintiffs contended that the test had not been proven to be reliable or valid for assessing job applicants in this particular setting. An expert witness for Dayton Hudson admitted that the use of Psychscreen resulted in a 61 percent rate of false positives. Thus, even if every unqualified applicant were identified by the test, more than 6 in 10 qualified applicants would also be rejected as unfit.

Dayton Hudson conceded that the intimate questions in Psychscreen constitute an invasion of privacy but added that the intrusion was minor and was justified by the company's needs. Employment application forms ask for some job-related personal information. Even though questions about religion and sex are not themselves job-related, they enable the interpreters of the test to evaluate psychological traits that are related to the job. Dayton Hudson was no

more interested than Frank Dry Goods in the personal life of its applicants for employment. The information gained by intimate questions was merely a means to an end.

### Do you think the Psychscreen testing was justified?

#### Compare Your Thoughts

Dayton Hudson's defense leaves two questions unanswered.

1. Does the company's need to administer the test offset the invasion of the applicants' privacy?
2. If so, could some less invasive means to achieve this end have been found?

Some critics argue that psychological testing is an invasion of privacy not only because of the intimate nature of the questions but also because the tests seek personal information, namely psychological traits, in ways that the person does not understand and is unable to control. That is, not only the means but also the end is intrusive. Thus, even if a test could be constructed without questions about religion, sex, or any other intimate subject, these critics hold that the test would still be an invasion of privacy.

## Points to Consider...

In 2013, the United States National Security Administration (NSA) was criticized by privacy advocates for its clandestine operation known as PRISM, which collected and analyzed vast amounts of telephone and digital communication data.<sup>3</sup> The NSA acquired this information from telecommunications companies, which were compelled to provide it by special "national security" warrants. Information was also obtained through the use of covert technology, which intercepted flows of digital information in and out of large Internet service providers. E-mail messages, file transfers, "voice over Internet" calls, transcripts of online chats, login locations, and other digital data were accessed as part of the program. The NSA collected this information ostensibly for the purpose of identifying international terrorist organizations, but experts have little doubt that the communications of ordinary American citizens were gathered as part of the program. The legality of PRISM remains the subject of ongoing debate.<sup>4</sup>

The criticism of the PRISM program illustrates that concerns about privacy are understandably centered today on the personal information collected and analyzed by government agencies. Privacy has become a major issue in government for many reasons. One is simply the vast amount of personal information that is gathered by government agencies. The need to protect this information became especially acute after the passage of the Freedom of Information Act (FOIA) in 1966, which allowed citizens to make requests for government-held information.

Intended by Congress to make government more accountable for its actions, the legislation had the unforeseen consequence of compromising the confidentiality of information about private individuals once it became accessible through FOIA requests.

### How long has the right to privacy been a public issue?

The Privacy Act of 1974 was designed in large part to resolve the conflict between government accountability and individual privacy. So great were the problems that Congress created the Privacy Protection Study Commission to investigate and make recommendations about further action. The National Labor Relations Board has long faced a similar problem with union demands for access to personnel files and other employee records. Unions claim that they need the information in order to engage in fair collective bargaining, but allowing unions to have unlimited access to this information without consent violates employees' right of privacy.<sup>5</sup>

As far back as 1979, a public opinion survey conducted by Louis Harris for the Sentry Insurance Company revealed that three out of four respondents believed that privacy should be regarded as a fundamental right akin to life, liberty, and the pursuit of happiness, and that half of them feared that American corporations do not adequately safeguard the personal information they gather.<sup>6</sup> Over 90 percent of those who responded said that they favored safeguards to prevent the disclosure of personnel and medical files to outsiders. A law granting employees access to the information collected about them was favored by 70 percent, and 62 percent wanted Congress to pass laws regulating the



kind of information that corporations may collect about individuals. In the United States, Congress and many state legislatures have responded with a patchwork of disparate laws governing privacy. In comparison, the protection of personal information is more advanced in the European Union with the adoption of the 1995 EU Data Protection Directive.

As evidenced by the public's response to the NSA's PRISM program, people today see the Internet as the most recent challenge to their privacy. The 2013 Pew Research Center Internet and American Life Project reports that 86 percent of individuals surveyed in the United States have taken specific steps to restrict or prevent access to their personal information online, citing concerns that companies can obtain personal information without their consent.<sup>7</sup> The Internet is not only the site for a large and growing percentage of commercial activity but also the primary means through which individuals communicate. It is not uncommon today for an individual's e-mail, data storage, social networking, and software services to be hosted by just one company, entirely online. This has prompted a number of observers to call large Internet service providers and Internet content providers, such as Google and Yahoo, "public utilities" of the information age.<sup>8</sup>

In addition to government surveillance, businesses also engage in a variety of practices that impact the privacy of individuals, both as employees and as consumers. This chapter examines the range of ethical issues in the impact of business on privacy. This examination includes a discussion of the meaning of a right to privacy and the arguments for the existence of this right. An understanding of this meaning is important in order not only to determine the limits of a right to privacy (When has one's privacy been invaded, for example?) but also to justify both the boundaries of this right (How far does it extend?) and its importance (Why be concerned about invasions of privacy?).

## 6.1: Challenges to Privacy

### 6.1 Identify how different business practices challenge the privacy of employees in the workplace and consumers in the marketplace

The two main sources of challenges to privacy are government and business. Whereas government challenges people's right to privacy in their single role as citizens, the challenge from business occurs in two roles—as employees in the workplace and as consumers in the marketplace.

#### 6.1.1: Privacy in the Workplace

In the early twentieth century, the Ford Motor Company set up a "Sociological Department" in order to make sure

that workers, in Henry Ford's words, were leading "clean, sober, and industrious" lives.<sup>9</sup> Company inspectors checked bank accounts to keep Ford employees from squandering their munificent \$5-a-day wages. They visited employees' living quarters to ascertain that they were neat and healthful, and they interviewed wives and acquaintances about the handling of finances, church attendance, daily diet, drinking habits, and a host of other matters. Workers who failed to live up to Henry Ford's standards of personal conduct were dismissed.

Employers today would scarcely dare to intrude so openly into the private lives of their employees, but they possess less obvious means for acquiring the information sought by Ford's teams of snooping inspectors—and some means that Henry Ford could not have imagined.

Among the tools available to present-day employers are

1. pencil-and-paper tests for assessing honesty and other personality traits of employees (as in the Dayton Hudson case),
2. quick and inexpensive drug tests,
3. extensive computer networks for storing and retrieving information about employees,
4. sophisticated telecommunication systems,
5. employer-issued mobile devices and portable computers, and
6. concealed cameras and microphones for supervising employees' work activities.

By administering medical insurance plans and providing on-site health care and counseling, employers are now in a position to know about employees' medical conditions. Some employers have also conducted genetic testing to screen employees for genes that make them more vulnerable to chemicals in the workplace and to workplace injuries.

Monitoring the work of employees is an essential part of the supervisory role of management, and new technologies enable employers to watch more closely than ever before, especially when the work is done on telephones or computer terminals. Supervisors can eavesdrop on the telephone conversations of employees, for example, and call up on their own screens the input and output that appear on the terminals of the operators.<sup>10</sup> A computer record can be made of the number of telephone calls, their duration, and their destination. The number of keystrokes made by a data processor, the number of errors and corrections made, and the amount of time spent away from the desk can also be recorded for use by management. Hidden cameras and microphones can also be used to observe workers without their knowledge. Even the activities of truck drivers can be monitored by a small computerized device attached to a vehicle that registers speed, shifting, and the time spent idling or stopped.

### Why are companies inclined to monitor employees and collect personal data?

Companies claim that they are forced to increase the monitoring of employees with these new technologies as a result of the changing nature of work. More complex and dangerous manufacturing processes require a greater degree of oversight by employers. The electronic systems for executing financial transactions and transferring funds used by banks and securities firms have a great potential for misuse and costly errors. In addition, employers are increasingly concerned about the use of drugs by workers and the high cost of employee theft, including the stealing of trade secrets. Employers also claim to be acting on a moral and a legal obligation to provide a safe workplace in which employees are free from the risk of being injured by drug-impaired coworkers.<sup>11</sup>

Employers require great amounts of data for the hiring and placement of workers, for the evaluation of their performance, and for the administration of fringe-benefit packages, including health insurance and pensions. Private employers also need to compile personal information about race, sex, age, and handicap status in order to document compliance with the law on discrimination. In addition, workers' compensation law and occupational health and safety law require employers to maintain extensive medical records. Alan F. Westin, an expert on privacy issues, observed that greater concern with employee rights in matters of discrimination and occupational health and safety has had the ironic effect of creating greater dangers to employees' right of privacy.<sup>12</sup>

Even efforts to improve employees' well-being can undermine their privacy. Wellness programs that offer medical checkups along with exercise sessions result in the collection of medical data, which can be used to terminate employees or defend employers against workplace injury claims. More than half of all U.S. employees have access to Employee Assistance Plans (EAPs) for help in handling personal problems and drug addictions. Although the information gained is generally held in confidence, it is available for company use when an employee files a workplace injury claim or sues for discrimination, wrongful discharge, or any other wrong. In some instances, employers have used the threat of revealing unrelated embarrassing information in court to dissuade employees from pressing a suit. Although the use of an EAP is usually voluntary, employees are often required to gain approval from an EAP counselor before seeking company-paid mental health care. Some employees thus face the choice of revealing their mental health condition to their company or paying for treatment out of pocket.

One particular area of concern has been psychological testing of the kind conducted by Dayton Hudson.

### Why did this means of evaluating employees become important?

Interest in psychological testing was spurred in the first half of the twentieth century by the "scientific management" ideas of Frederick Taylor and the development of the field of applied or industrial psychology. The massive testing programs of the armed forces in two world wars were carried over into civilian life by large American corporations. Employers have increasingly come to recognize that an employee's psychological traits are important, not only for predicting successful job performance but also for identifying potentially dishonest and troublesome employees. Use of the pencil-and-paper tests has been spurred by the banning of mechanical polygraph ("lie detector") testing in 1988 and by the reluctance of former employers to reveal any but the most basic information. Studies by the congressional Office of Technology Assessment and the American Psychological Association have found that some tests have moderate predictive value but that others are virtually worthless.

The key questions about employee privacy concern what information an employer may rightly possess and how this information may be used. Whether the possession of such personal information is legitimate depends, in part, on the nature of the relationship between an employee and an employer. At the heart of this relationship is the fact that employees are agents of their employer. Employees act on behalf of their employer and have special responsibilities to work as directed, perform their tasks with competence and care, and promote the employer's interests. Employers have strong economic interests to ensure that employees meet these expectations, and the possession of information about their employees may be essential for assessing whether these expectations have been met. Certain information is also important in determining whether an employee should be fired for cause or which employees to terminate when lay-offs are required by changing circumstances. For these reasons, employers have used various means to monitor the activities of their employees, both on and off the job.

## 6.1.2: Privacy in the Marketplace

Consumers have joined employees as targets for information gathering by corporations. The same surveillance techniques that are used to monitor employees are now used, for example, to detect theft by store customers. Video cameras are commonplace in stores, and some retailers have installed hidden microphones as well. Consumers are the main target of information collection and utilization on the Internet, which is a major focus of this chapter.

Imagine that most of the stores you entered created a record of your visit including not only your purchases but also what merchandise you looked at, how long you took, what route you followed through the store, what other stores you had visited, and what you bought there. Imagine

further that, in many instances, the store could connect this information with your name; address; telephone number; and perhaps your age, income level, and lifestyle. You would probably have the feeling that your shopping activity was being closely scrutinized and that you lacked virtually any privacy while browsing. This situation, which most people would find alarming in a shopping mall, is routine on the Internet.

Concern about consumer privacy has focused primarily on the gathering and use of information in database marketing. Businesses have discovered that it pays to know their customers. For example, grocery stores that issue identification cards that are scanned along with the universal product code on each product are able to construct detailed profiles of each customer's purchasing preferences. This information may be used in many ways, including the making of offers that are tailored to appeal to specific customers.

The growth in database marketing has been facilitated by computer technology, which is able to combine data from many sources and assemble them in usable form. For example, by merging information about an individual with census data for that person's zip-code-plus-four area, it is possible to make reliable inferences about income, lifestyle, and other personal characteristics. Companies that specialize in data collection can provide direct marketers with customized mailing lists that target groups with the desired characteristics, as discussed in the Information Handling at ChoicePoint case. Such targeted selling through direct mail is potentially beneficial to consumers because a customized mailing list is more likely to produce offers of interest to consumers than is a random mailing.

In recent years, the use of database marketing has shifted from direct mail to Internet advertising. The collection of information about individuals' Internet activities, including their online searches, purchasing behavior, and social networks, has immense potential for marketers. Indeed the newest challenge to privacy is the emergence of information technology that combines and analyzes information from seemingly disparate sources. Market consulting firms can more easily "aggregate" information from online activities to identify and target potential customers with much greater precision than before.

One issue in the use of database marketing to generate mailing lists and online advertising is the right of control over information. If we reveal some information about ourselves to a company, does that company "own" the information? For example, does a magazine have a right to sell a list of its subscribers to a direct marketer? We voluntarily provide our name and address to the magazine for the purpose of obtaining a subscription, just as we reveal our annual income to a bank in order to obtain a loan. These are examples of the *primary* use of information. The use of information for some other purpose is labeled *secondary*. Some privacy advocates hold that there should be no

secondary use of information without a person's knowledge and consent. Thus, some magazines inform subscribers that they make their list available for direct mail and allow subscribers to "opt out" by removing their name and address from the list. In general, the secondary use of any information in a loan application is prohibited by law.

Other issues concern access to information and potential misuse. Although an individual's annual income is generally regarded as personal, people may not be upset to learn that this information is used to generate a mailing list—as long as no one has access to the information itself. A direct marketer has no interest in knowing a particular person's income but only whether that person is a likely prospect for a sale. The fact that a person's name and address are on a list does not reveal to anyone that person's income, and the list itself is only used for mailing purposes and is not publicly disclosed. However, some information is considered too sensitive to be included in a marketing database. Health information has generally fallen into this category, but pharmaceutical companies now seek mailing lists of patients with particular conditions. For example, *Reader's Digest* obtained completed questionnaires on health problems from 9 million subscribers and made it available for advertisers of pharmaceutical products for specific ailments.<sup>13</sup> Patients' records, prescription data from pharmacies, and even calls to the toll-free numbers of pharmaceutical companies are resources for information gatherers.<sup>14</sup>

Ethical questions about employee and consumer privacy are unavoidable because obtaining and using personal information are essential in employment and in some purchasing activity. However, everyone also has a legitimate interest in maintaining a private life that is free from unwarranted intrusion by business. Finding the right balance between the rights of everyone concerned is not a simple task. A set of guidelines or a company code on employee and consumer privacy must address an immense number of different questions. Before attempting to find a balance between these competing rights, though, it is necessary to inquire into the meaning of privacy as an ethical concept.

## 6.2: Meaning and Value of Privacy

### 6.2 Explain the concept of privacy and how utilitarian and Kantian arguments can be used to defend a right to privacy

A definition of privacy has proven to be very elusive. After two years of study, the members of the Privacy Protection Study Commission were still not able to agree on one. Much of the difficulty is due to the diverse nature of the many different situations in which claims of a right of

privacy are made. Even the narrower concept of privacy for employees and consumers is applied in such dissimilar circumstances that it is not easy to find a common thread running through them.

### 6.2.1: History of the Concept

As a legal concept, privacy dates only from the late nineteenth century. There is no mention of privacy in the original Constitution or the Bill of Rights. Although a number of rights related to privacy have long been recognized in American law, they have generally been expressed in terms of freedom of thought and expression, the right to private property, protection from “unreasonable searches and seizures,” and other constitutional guarantees. The first sustained discussion of privacy occurred in an 1890 article in the *Harvard Law Review* written by two young attorneys, Samuel Warren and Louis Brandeis (who later became a famed justice of the Supreme Court).<sup>15</sup>

Warren and Brandeis were concerned mainly with the publication of idle gossip in sensation-seeking newspapers. The aim of privacy laws, they thought, should be to protect “the privacy of private life” from unwanted public exposure, and their proposals all dealt with limits on the publication of information about the private lives of individuals. In his celebrated dissenting opinion in *Olmstead v. United States*, a 1928 case concerning the constitutionality of telephone wiretapping, Brandeis wrote that the right of privacy is “the right to be let alone—the most comprehensive of rights and the right most valued by civilized men.”<sup>16</sup>

The theory of privacy presented by Warren and Brandeis was slow to gain acceptance. It was rejected by the courts in a number of cases around the turn of the century in which the names and pictures of prominent persons were used to advertise products. The public uproar over one of these cases prompted the New York legislature to enact a law prohibiting the commercial use of a person’s name or likeness without permission.<sup>17</sup> Gradually, most states followed the lead of New York in granting persons a right to be free of certain kinds of intrusion into their private lives. But it was not until 1965 that the Supreme Court declared privacy to be a constitutionally protected right. The decision came in *Griswold v. Connecticut*, which concerned the right of married couples to be free of state interference in the use of contraceptives.<sup>18</sup>

Some philosophers and legal theorists have argued that the concept of privacy does not introduce any new rights into the law but merely expresses several traditional rights in a new way. Consequently, our legal system already contains the resources to protect individuals against these wrongs without creating a distinct right of privacy.<sup>19</sup> For example, disclosing embarrassing facts about a person or intruding into his or her solitude might be described as inflicting mental distress, and the publication of false accusations could be said to constitute libel or

defamation of character. What, these critics ask, does the concept of privacy add to other, better-established rights?

### 6.2.2: Defining Privacy

The literature contains many attempts to elucidate privacy as an independent right that is not reducible to any other commonly recognized right. Three definitions in particular merit examination.

1. *The Right to Be Let Alone.* The first definition, which derives from Warren and Brandeis and finds expression in *Griswold v. Connecticut*, holds that privacy is the right to be let alone. A similar view of privacy was expressed by the majority in *Griswold*. Laws governing the use of contraceptives intrude into an area of the lives of individuals where they have a right to be let alone. Justice William J. Brennan expanded the view expressed in *Griswold* in a subsequent birth control case:

If the right to privacy means anything, it is the right of the individual, married or single, to be free from unwarranted government invasion into matters so fundamentally affecting a person as the decision whether to bear or beget a child.<sup>20</sup>

Many critics of this view have pointed out that the phrase “to be let alone” is overly broad.<sup>21</sup> Individuals have a right “to be let alone” in matters of religion and politics, for example, but legal restrictions on religious practices, such as snake handling, or on political activities, such as the making of political contributions, do not involve violations of privacy. At the same time, the Warren and Brandeis definition is too narrow because some violations of privacy occur in situations where there is no right to be let alone. Workers have no right to be free of supervision, for example, even though it can be claimed that their privacy is invaded by the use of hidden cameras to monitor their activity secretly.

These objections, in the view of critics, are merely symptoms of a deeper source of error in the Warren and Brandeis definition, which is the confusion of privacy with liberty. These examples show that a loss of liberty is neither a necessary nor a sufficient condition for a loss of privacy. Perhaps greater clarity is achieved by limiting the concept of privacy to matters involving information and not stretching the concept to include all manner of intrusions into our private lives. Thus, cases in which companies refuse to hire smokers are better analyzed as limitations of liberty rather than invasions of privacy. This suggestion is reflected in the second definition of privacy.

2. *The Right to Control Access to Personal Information.* Privacy also has been defined as control over information about ourselves.<sup>22</sup> According to Alan F. Westin, “Privacy is the claim of individuals . . . to determine for

themselves when, how, and to what extent information about them is communicated to others.”<sup>23</sup> This definition is open to the same charge: It is at once too broad and too narrow. Richard B. Parker observes, “Not every loss or gain of control over information about ourselves is a gain or loss of privacy.”<sup>24</sup> Furthermore, all definitions of privacy as exercising control flounder on the fact that individuals can relinquish their own privacy by voluntarily divulging all sorts of intimate details themselves.<sup>25</sup> There is a loss of privacy under such circumstances but not a loss of control. Therefore, privacy cannot be identified with control.

3. *Having Secrets Remain Secret.* A third, more adequate definition of privacy holds that a person is in a state of privacy when certain facts about that person are not known by others. W. A. Parent, in an important 1983 article, “Privacy, Morality, and the Law,” defines privacy as “the condition of not having undocumented personal knowledge about one possessed by others.”<sup>26</sup> By the phrase “personal knowledge,” Parent does not mean all information about ourselves but only those facts “which most individuals in a given society at any given time do not want widely known.”<sup>27</sup> It is necessary that the definition be restricted to *undocumented* personal information, because some facts that individuals commonly seek to conceal are a matter of public record and can be known without prying into their private lives. A person does not suffer a loss of privacy, for example, when a conviction for a crime becomes known to others because court records are public documents. Similarly, there is no loss of privacy when an easily observable fact, such as a person’s baldness, is known to others, even if the person is sensitive about it and prefers that others not be aware of it.

In the remaining discussion, the concept of privacy is limited to matters involving information and, in particular, to the access of others to undocumented personal information, as described by Parent. The two other definitions—as a right to be let alone and to have control over information about ourselves—confuse privacy with other values. Having gained some understanding of the concept of privacy, we can now turn to the question of why privacy is a value.

### WRITING PROMPT

#### Personal Definitions of Privacy

Which definition of privacy is closest to your understanding of the term? In your own words, explain how the third definition differs from the first two.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 6.2.3: Utilitarian Arguments

Why do we value privacy so highly and hold that it ought to be protected as a right?

Certainly, we desire to have a sphere of our life in which others do not possess certain information about us. But the mere fact that we have this desire does not entail our having a right of privacy; nor does it tell us how far a right of privacy extends. Some arguments are needed, therefore, to establish the value of privacy and the claim that we have a right to it. Most of the arguments developed by philosophers and legal theorists fall into one of two categories. One category consists of utilitarian arguments that appeal to consequences, and the second is Kantian arguments that link privacy to being a person or having respect for persons. To a great extent, these two different kinds of arguments express a few key insights about privacy in slightly different ways.

One of the consequences cited by utilitarians is that great harm is done to individuals when inaccurate or incomplete information collected by an employer is used as the basis for making important personnel decisions. The lives of many employees have been tragically disrupted by groundless accusations in their personnel records, for example, and the results of improperly administered polygraph and drug tests. Even factual information that ought not to be in an employee’s file, such as the record of an arrest without a conviction, can cause needless harm. The harm from these kinds of practices is more likely to occur and to be repeated when employees are unable to examine their files and challenge the information (or misinformation) in them.

A drawback to this argument is that it rests on an unproved assumption that could turn out to be false. It assumes that on balance more harm than good will result when employers amass files of personal information, use polygraph machines, conduct drug tests, and so on. Whatever harm is done to employees by invading their privacy has to be balanced, in a utilitarian calculation, against the undeniable benefits that these practices produce for both employers and employees.

Furthermore, the argument considers only the possible harmful consequences of privacy invasions. However, some practices, such as observing workers with hidden cameras and eavesdropping on business conducted over the telephone, are generally considered to be morally objectionable in themselves, regardless of their consequences. Honest workers, for example, have nothing to fear from surveillance that is designed to protect against employee theft, and indeed the use of hidden cameras in a warehouse can even benefit those who are honest by reducing the possibility of false accusations. Still, workers have a right to complain that secret surveillance of their activities on the job violates the right to privacy. It is the

fact that they are subjected to constant observation and not any possible consequence of being observed that is morally objectionable.

This objection is avoided by more sophisticated utilitarian arguments that do not locate the harmful consequences solely in the harm that occurs when information is misused. According to these arguments, a certain amount of privacy is necessary for the enjoyment of some activities, so that invasions of privacy change the character of our experiences and deprive us of the opportunity for gaining pleasure from them. Monitoring and surveillance in the workplace, for example, affect job satisfaction and the sense of dignity and self-worth of all workers. They send a message to employees that they are not trusted and respected as human beings, and the predictable results are a feeling of resentment and a decline in the satisfaction of performing a job.

**Example:** An illustration of this point is provided by a truck driver with 40 years' experience with the Safeway Company who reports that he used to love his job because "you were on your own—no one was looking over your shoulder. You felt like a human being." After the company installed a computerized monitoring device on his truck, he decided to take early retirement. He complains, "They push you around, spy on you. There's no trust, no respect anymore." A directory-assistance operator reported, "I've worked all those years before monitoring. Why don't they trust me now? I will continue to be a good worker, but I won't do any more than necessary now."<sup>28</sup>

Some writers argue that privacy is of value because of the role it plays in developing and maintaining a healthy sense of personal identity. According to Alan F. Westin, privacy enables us to relax in public settings, release pent-up emotions, and reflect on our experiences as they occur—all of which are essential for our mental well-being. A lack of privacy can result in mental stress and even a nervous breakdown.<sup>29</sup> Another common argument appeals to the importance of privacy in promoting a high degree of individuality and freedom of action among the members of a society. Critics of these arguments object, however, that there is little evidence that privacy has the benefits claimed for it or that the predicted harm would follow from limiting people's privacy.<sup>30</sup> Many societies function very well with less room for solitude than our own, and the experiences of human beings in prisons and detention camps are cited by critics to refute these arguments.

#### 6.2.4: Kantian Arguments

Two Kantian themes that figure prominently in defense of a right to privacy are those of autonomy and respect for

persons. Stanley I. Benn, for example, notes that utilitarian arguments for a right of privacy are not able to show what is morally wrong when a person is secretly observed without any actual harm being done. "But respect for persons," Benn claims, "will sustain an objection even to secret watching, which may do no actual harm at all." The reason, he explains, is that covert spying "deliberately deceives a person about his world," which hinders his ability to make a rational choice.<sup>31</sup> Benn's argument thus appeals to both Kantian themes by arguing that invading a person's privacy violates the principle of respect for persons *and* prevents a person from making a rational choice as an autonomous being.

Hyman Gross argues in a similar vein that what is morally objectionable about being observed unknowingly through a hidden camera or having personal information in a data bank is that a person loses control over how he or she appears to others.<sup>32</sup> If people form incomplete or misleading impressions of us that we have no opportunity to correct, then we are denied the possibility of autonomous or self-directed activity, which is a characteristic of human beings. Hence, invasions of privacy diminish an essential condition for being human.

In a very influential discussion, Charles Fried argues that privacy is of value because it provides a "rational context" for some of our most significant ends, such as love, friendship, trust, and respect, so that invasions of privacy destroy our very integrity as a person.<sup>33</sup> The reason that privacy is essential for respect, love, trust, and so on is that these are intimate relations, and intimacy is created by the sharing of personal information about ourselves that is not known by other people. In a society without privacy, we could not share information with other people (because they would already know it), and hence we could not establish intimate relations with them. Thus, monitoring, in Fried's view, "destroys the possibility of bestowing the gift of intimacy, and makes impossible the essential dimension of love and friendship."<sup>34</sup> Similarly, trust cannot exist where there is monitoring or surveillance, because trust is the expectation that others will behave in a certain way without the need to check up on them.

The arguments of Benn, Gross, Fried, and others seize upon important insights about the value of privacy, but many critics have found flaws in the details of their arguments. Jeffrey H. Reiman, for one, objects that it is too strong to assert that all instances of people being watched unknowingly result in deceiving people and depriving them of a free choice. Otherwise, we would be violating people's right of privacy by observing them strolling down a street or riding a bus.<sup>35</sup> Intimate relations such as love and friendship do not consist solely in the sharing of information but involve, as one writer says, "the sharing of one's total self—one's experiences,

aspirations, weaknesses, and values.”<sup>36</sup> Consequently, these relations can exist and even flourish in the absence of an exclusive sharing of information.

Several philosophers have suggested that the key to a more satisfactory theory of privacy can be constructed by understanding the way in which individuals form and identify and are socialized in our culture.<sup>37</sup> Privacy, in the view of these philosophers, is neither a necessary means for realizing certain ends nor conceptually a part of these ends. Nevertheless, we are trained from early childhood to believe that certain things are shameful (for example, public nudity) and others strictly our own business (such as annual income). There is no intrinsic reason why our bodies or our financial affairs should be regarded as private matters. People at different times and places have been socialized differently with regard to what belongs to the sphere of the private, and we might even be better off if we had been socialized differently. Still, we have been socialized in a certain way. In our culture, certain beliefs about what ought to be private play an important role in the process by which a newborn child develops into a person and by which we continue to maintain a conception of ourselves as persons.

This argument is broadly utilitarian. The consequences that it appeals to, however, are not the simple pleasures and pains of classical utilitarianism or even the notions of mental health and personal growth and fulfillment of more sophisticated utilitarian arguments. The argument goes deeper by appealing to the importance of privacy for personhood, a concept that is more commonly used by Kantian theorists. Unlike Kantian arguments, though, this one recognizes that privacy is not necessary for all people in all times and places but is merely a value specific to contemporary Western culture. There are societies that function very well with less privacy than we are accustomed to; however, given the role privacy plays in our socialization process, a certain amount is needed for us to develop as persons and have a sense of dignity and well-being.

#### **What do the utilitarian and Kantian arguments for a right to privacy have in common?**

Both utilitarian and Kantian arguments point to a key insight: Privacy is important in some way to dignity and well-being. They claim too much, however; privacy is not absolutely essential to either one, except insofar as we have come to depend on it. For better or worse, privacy has become an important value in our culture, and now that it has, it needs to be maintained. Privacy is like the luxury that soon becomes a necessity, but “necessary luxuries” are not less valuable just because we could formerly get by without them. The utilitarian and Kantian justifications of privacy just offered are thus the most adequate ones we have.

## 6.3: Privacy Away from Work

### **6.3 Evaluate the reasoning that leads a company to monitor its employees and the measures undertaken to limit such monitoring**

Deborah Ehling, a registered nurse and a paramedic in New Jersey, brought suit against her former employer, a hospital and medical clinic, claiming that she was wrongly fired for her private, off-duty posts on Facebook.<sup>38</sup> Her remarks, which were accessible only to her network of Facebook friends, criticized the actions of paramedics in Washington, DC, who had saved the life of a gunman who had opened fire in a museum, killing one guard and being wounded in the exchange of shots. Ehling said that the paramedics should have let the wounded gunman die rather than heroically saving him. Her supervisor allegedly accessed this post after a coworker, who happened to be one of Ehling’s Facebook friends, forwarded it to the hospital’s management. Ehling’s employer subsequently terminated her employment on the grounds that her Facebook post indicated a general disregard for patient welfare, which was incompatible with her role as a nurse and paramedic.

Cases like this raise questions about the reach of employers’ control.

Is it right for employers to regulate aspects of employees’ lives off the job? Should an employee’s “off the clock” hours, for which they are presumably not being paid, be a sphere of privacy, free from an employer’s heavy hand or prying eyes?

Employees generally accept that employers have legitimate reasons for monitoring their activities and collecting pertinent information when they are at work or are using company equipment, such as cell phones and computers, off the job. Some employers, however, have sought to track the activities of employees and collect personal information when employees are away from work, on their own time. The most common policy for such round-the-clock enforcement is a prohibition on drug use, which is sometimes extended to smoking by companies that refuse to employ smokers. Many companies have no-smoking policy, which prohibits smoking on the job, but some have a no-smokers policy—no smoking at all!

#### 6.3.1: Justifying Monitoring

There are two arguments for justifying “off the clock” policies and monitoring to enforce them.

**One argument is that personal behavior, even when it takes place away from work, can indirectly impact the ability of an employee to perform well on the job.**

Employers, for example, are reasonably concerned about the use of drugs by workers and randomly test for drug use in order to provide a safe workplace, so that other employees are free from the risk of being injured by a drug-impaired coworker.<sup>39</sup> Drug use, whether it occurs on the workplace premises during working hours or off-site on the employee's own time, still affects work performance and the workplace environment. Testing for drug use benefits not only the company but all employees as well.

**The second argument is that what an employee does in his or her spare time can substantially increase the costs of doing business.** One cost of doing business that has exerted significant pressure on businesses in recent years is health insurance. The cost of providing insurance coverage has prompted some companies to take a more active role in monitoring the personal activities of their employees. Employee wellness programs are a popular tool for helping companies to reduce the cost of providing health insurance by encouraging employees to lead healthier lives.<sup>40</sup> These programs characteristically involve the collection of employees' health-related metrics, such as weight, blood pressure, and cholesterol levels, in order to track the health of the employee group over time. Companies also offer incentives for workers to participate in wellness activities, such as company-sponsored fitness events, off-site health seminars, health club use, and smoking cessation programs.

The main benefit of a wellness program is that insurance companies offer lower, group-rate insurance premiums to companies that have a wellness program in place. Critics note, however, that despite employers' economic interest in lowering its health-related expenses, employees who are dependent on their employer for health insurance have little choice but to submit to monitoring and disclosure of their personal health information. They also note that some employers are already using their wellness program data to determine how much particular employees must pay for health insurance.<sup>41</sup> In some companies, employees must pay higher premiums if they or a covered member of their family smokes.

As previously mentioned, health-related costs have also prompted some companies to require that their employees refrain from tobacco use. Employees who smoke are more likely to miss work and utilize health insurance at higher rates than employees who do not. A study by Texas Instruments found that the cost of a smoker's health care was 50 percent greater than that of a non-smoker.<sup>42</sup> Testing for smoking has been used as a mechanism to limit those costs, either by dismissing employees who test positive for tobacco use or by giving those employees who test positive a certain period of time to demonstrate that they have stopped smoking.<sup>43</sup>

In addition to direct costs, such as the impact of smoking on medical insurance premiums, an employee's

off-the-job behavior can result in other, indirect costs by impacting the operation of the business or by tarnishing a company's reputation. One arena for off-duty conduct that is now under increasing scrutiny by employers is employee's use of social media. There is a growing list of employers that have taken action against employees who have posted objectionable statements or photographs through blogs or social networking sites. A highly publicized incident involved a Delta flight attendant, Ellen Simonetti, who was fired in 2004 for "inappropriate behavior." The cause was posting pictures of herself in uniform aboard planes between flights, with one shot showing just a patch of her brassiere.<sup>44</sup> Simonetti is unsure how managers at Delta happened upon her blog, which never mentioned the airline or her last name (she referred to herself as "Queen of the Sky"). However, the chance of being detected for online activity has been increased by the growth of outside firms, such as Social Intelligence Corporation, which assist employers by scouring the Internet for information about current and prospective employees.<sup>45</sup>

### WRITING PROMPT

#### "Off the Clock" Monitoring

Explain whether you find the arguments for monitoring employees' actions away from work convincing. Who benefits most from these policies—the employer or employees? What is a possible Kantian counterargument to these justifications?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 6.3.2: Limits to Monitoring

Social network sites, such as Facebook, Twitter, and Google+, have both public and private dimensions. Some of the information shared on these sites is limited to one's social network or group of "friends," whereas other information is publicly available to anyone with a computer. This distinction is important in determining whether an employer's scrutiny of an employee's social network site is legitimate. An employee who knowingly posts publicly accessible material has no expectation of privacy, and so an employer would not be violating an employee's privacy by accessing it. (Whether an employer would be justified in taking adverse action based on this information is another matter.) More problematic are situations where employees are disciplined on the basis of social network activities for which there is a reasonable expectation of privacy, as in the case of Deborah Ehling. A federal court eventually ruled that although Ehling expected her comments to remain private, the employer obtained them



through permissible means and did not violate the law either by receiving the information or in terminating her employment on the basis of it.

Efforts are under way, however, to limit employers' use of the private information posted on social network sites in employment decisions. Employers in a number of states are now prohibited by law from requiring employees or applicants to disclose their user names or passwords for social network sites or to open these sites for inspection by employers.<sup>46</sup> However, some legal scholars contend such prohibitions are unnecessary if the information obtained from private social networking sites is used in ways that violate other laws.<sup>47</sup>

### Examples

- Discrimination on the basis of religion is illegal under the 1964 Civil Rights Act, and so an employer who learns of a person's religious affiliation from a Facebook post would be prohibited from using this information in making any personnel decision in a discriminatory manner.
- Similarly, if an employee's private Facebook page contained criticism of the pay or working conditions at his place of employment, then the National Labor Relations Act, which protects the concerted activity of employees to discuss the terms and conditions of employment with other employees, would prohibit an employer from using the employee's messages as grounds for termination.<sup>48</sup>

Underlying the ethical challenges to employment-related monitoring and information collection is the complicating fact that an employee is simultaneously an agent of his employer and an individual with a life apart from work. An employee is not simply an employee, but also a person with needs, interests, and plans independent of his or her job.

How can employers recognize this dual identity of employees and thereby respect individual autonomy?

One way is for an employer to disclose information about the manner in which it seeks to monitor an employee's conduct and collect information. Armed with this knowledge, employees can make their own decisions about how to best balance their private life with their role as an employee. Ideally, a company's disclosure should clearly provide a formal notification of how, when, and under what circumstances monitoring will take place. This includes an identification of the specific information that will be collected and an explanation of the technologies and communication platforms that are subject to employer oversight.<sup>49</sup> Ideally, a full policy of disclosure should also provide a rationale for the employer's monitoring and information collection efforts. This added level of transparency can have the positive effect of minimizing the common perception

that monitoring and information collection by employers is occurring arbitrarily, without good reasons.

In addition to full and open disclosure, employers can take an important cue from the legal limits on government monitoring and collecting of information about citizens.

### What limit on government is also applicable to businesses?

Government agencies, especially those in law enforcement, usually must demonstrate a cause of action before collecting information about an individual's private activities. The similar notion is applicable in employment. A company may have a variety of means to "watch" its employees, but this capability should not be used without good reason. Monitoring and information collection, in other words, should be used selectively in order to limit the number of occasions when an employer seeks access to undocumented personal information that might reasonably be considered private from the employees' point of view.

### Examples

- There is a significant difference between a company policy that regularly and randomly surveys the social networking activities of its employees and a company policy that does so only when there is good reason to believe that an employee has used a social network account improperly.
- An employer can archive e-mail communications but refrain from screening those e-mails unless it has cause to believe that an employee is using an e-mail account contrary to company policy.

In some instances, the purposes for monitoring can be achieved by aggregating collected data without linking the information to specific individuals.<sup>50</sup> Ensuring that monitoring and information collection is limited in these ways balances the employer's interests in assuring that employees act as responsible agents with the employees' interests in maintaining some measure of control over personal information.

## 6.4: Privacy of Employee Records

### 6.4 Determine what ethical issue(s) are associated with a particular handling or use of employee records and whether the action is justified or a violation of the employee's privacy

Although privacy is an important value that ought to be protected, there are many instances in which other persons and organizations are fully justified in having personal information about others and thereby in intruding into their private lives. The task of justifying a right of privacy,

then, consists not only in demonstrating the value of privacy, but also in determining which intrusions into our private lives are justified and developing effective policies governing these intrusions.<sup>51</sup>

### 6.4.1: Ethical Issues with Records

Among the ethical issues to be addressed in developing the case for a right of privacy in employee records, and then in formulating a company privacy protection plan for these records, are the following:

1. The kind of information that is collected.
2. The use to which the information is put.
3. The persons within a company who have access to the information.
4. The disclosure of the information to persons outside the company.
5. The means used to gain the information.
6. The steps taken to ensure the accuracy and completeness of the information.
7. The access that employees have to information about themselves.

The first three issues are closely related, because the justification for an employer's possessing any particular kind of information depends, at least in part, on the purpose for which the information is gathered. Some information is simply of no conceivable use in company decision making and constitutes a gratuitous invasion of employee privacy. It is more often the case, however, that an employer has a need or an interest that provides some

justification for intruding into the private lives of employees. An invasion of employee privacy is justified, however, only when the information is used for the intended purpose by the individuals who are responsible for making the relevant decisions.

Companies are generally justified in maintaining medical records on employees in order to administer benefit plans, for example, and to monitor occupational health and safety. If these are the purposes for which a company gathers this kind of information, then it follows that

1. only medical information that is essential for these purposes can be justifiably collected,
2. only those persons who are responsible for administering the benefit plans or monitoring the health and safety of employees are justified in having access to the information, and
3. these persons must use the information only for the intended purposes.

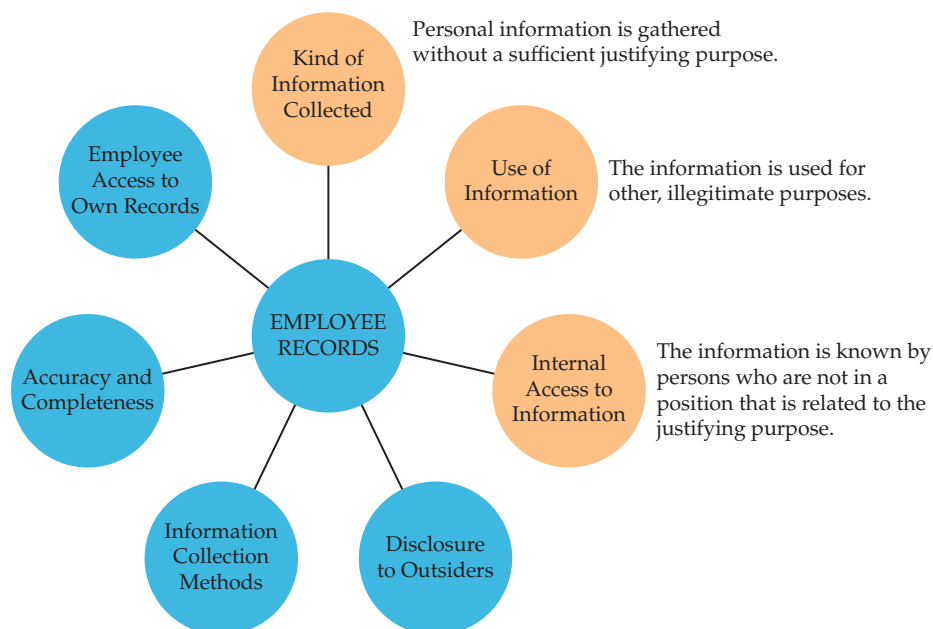
Figure 6.1 shows three corresponding ways in which employees' right of privacy can be violated.

### 6.4.2: Justifying a Purpose

Obviously, the notion of a justifying purpose plays a critical role in determining the exact scope of the right of privacy in employment. There is considerable room for disagreement on the questions of whether any given purpose is a legitimate one for a business firm to pursue, whether a certain kind of information is essential for the pursuit of a particular purpose, and whether the information is in fact being used for the intended purpose. Companies have an interest and, indeed,

an obligation to ensure that employees are capable of performing physically demanding work and are not subjected to undue risk, for example. The purposes for which Henry Ford created the Sociological Department, however, went beyond this concern to include a paternalistic regard for the general welfare of his employees, which is not a legitimate purpose. Even to the extent that the work of the inspectors from the Ford Motor Company was justified by a legitimate purpose, there could still be an objection to the excessive amount of information they sought. Information about the handling of finances, church attendance, and eating and drinking habits is more than the company needed to know.

**Figure 6.1** Some Privacy Issues with Employee Records



Determining the purpose for which information is being used can raise difficult questions about intentions. A controversy was sparked in 1980, for example, when it became publicly known that the DuPont Company was routinely screening black applicants at a plant in New Jersey for signs of sickle-cell anemia. The company asserted that the purpose for conducting the screening was to protect black workers, because carriers of the disease, who are mostly black, were thought to be more vulnerable to certain chemicals used at the plant. Such a purpose is arguably legitimate, but some critics of DuPont charged that the company was actually using genetic screening for another purpose, namely, to prevent liability suits and to avoid having to protect workers from dangerous chemicals.<sup>52</sup>

Is there any way in which the notion of a justifying purpose can be clarified so that such disagreements can be resolved?

One possibility is to specify the conditions necessary for a business to conduct normal operations. In order to do this, a company must be able to assess the suitability of applicants for employment, supervise their work-related behavior, administer fringe-benefit plans, and so on. In addition, employers must be able to acquire the information necessary for complying with legal requirements about taxes, social security, discrimination, health and safety, and the like. As a result, employers are justified in asking potential employees about their educational background, past employment, and so on, but not, for example, about their marital status because this information is not necessary in order to make a decision about hiring. Once employees are hired, a company may have a need to inquire about marital status in order to determine eligibility for medical benefits, but only if the employee in question chooses to participate in a medical insurance plan. Even then, this information should be used only for the purpose of determining eligibility for medical benefits.

Joseph R. DesJardins suggests that questions about the extent of the right of privacy in the workplace can be settled by appealing to a contract model of the employer-employee relationship.<sup>53</sup> Viewing employment as a contractual relation between an employer and an employee provides a basis for granting a set of rights to both parties because the validity of contracts requires that certain conditions be satisfied.

- **Contracts are valid, first, only if they are free of force and fraud.** As a result, an employer has a right to require applicants to provide enough information to make an informed decision about hiring and to submit to tests for measuring relevant aptitudes and skills. Once hired, employees have an obligation to permit employers to monitor work performance, for example,

and to gather whatever information is necessary to maintain an ongoing contractual relation.

- **Second, valid contracts also require mutual voluntary consent,** so a contract model of employment would not permit employers to collect information without the knowledge and permission of the employees affected. Covert searches, surveillance by hidden cameras, the use of private investigators, and so on would be incompatible with the view of employment as a contractual relation. Similarly, objections could be raised to employer demands that employees either submit to drug tests and interrogation with a polygraph machine or be dismissed because an employee has little choice but to comply. Union contracts in which employees are able to exercise effective choice often contain provisions prohibiting such practices.

### WRITING PROMPT

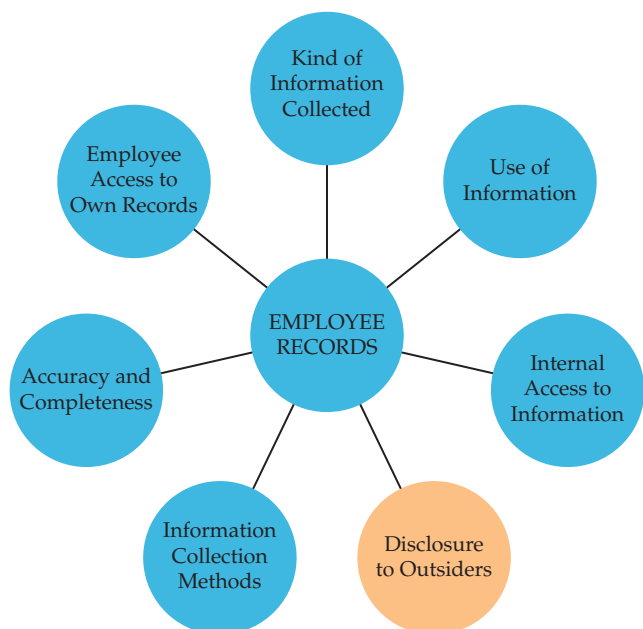
#### Information about Pregnancy

Federal law does not prohibit employers from asking current employees and job applicants if they are pregnant or planning to have children. Employers typically refrain from doing so, however, given concerns that pregnancy-related discrimination is illegal. When might an employer have a legitimate reason for requesting this information? Explain how the use of this information could be justified?

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Submit

### 6.4.3: Disclosure to Outsiders



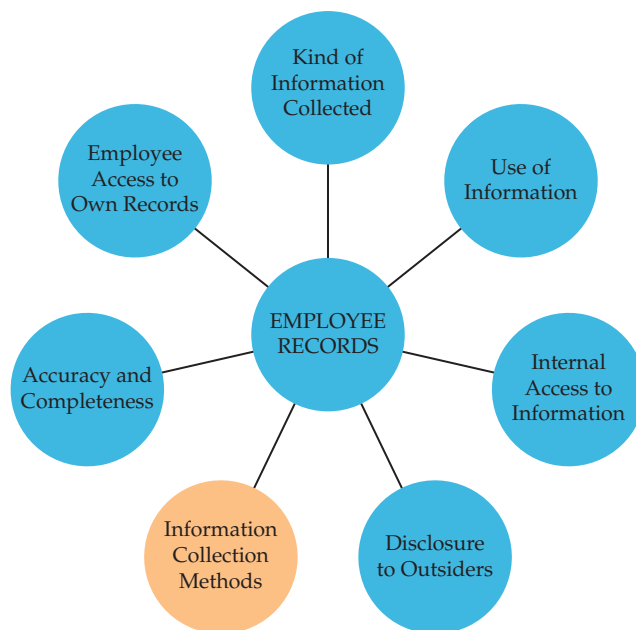
The fourth issue—concerning the disclosure of personal information to persons outside a company—arises because of the practice, once very common, of employers sharing the content of personnel files with landlords, lending agencies, subsequent employers, and other inquiring persons without the consent of the employees involved. Even when there is a legitimate purpose that would justify these various parties having the information, it can be argued that an employer has no right to provide it because the employer is justified in collecting and using information only for purposes connected with the employer–employee relationship. What is morally objectionable about an employer’s disclosing personal information to an outside party, in other words, is not necessarily that the outside party is not justified in having it but that the employer has no justification for giving it out.

Thus, medical records collected by a former employer ought not to be passed along to a subsequent employer without the employee’s consent. The former employer presumably had a purpose that justified the gathering of that information, and the new employer might also have a similar purpose in gathering the same information. But with the former employer, the information pertains to that employment relation and can be justifiably used only for purposes connected with it. The subsequent employer must proceed in the same way as the former employer.

This argument points up an important difference between personal information and other kinds of corporate records. Databases of various kinds are generally regarded as resources that are *owned* by a company. Ownership, however, generally entails an exclusive and unrestricted right of access and control, which employers do not have with respect to personal information. A mailing list, for example, is a kind of property that a company can use in any way it pleases, with no restrictions. Medical records, by contrast, can be compiled by a company only for a specific purpose, and any use unrelated to this purpose is prohibited. The fact that employers bear a burden of proof for justifying the collection and use of personal information shows that the notion of ownership is inappropriate in this case.<sup>54</sup>

It is also inappropriate to describe the information in personnel files as belonging to employees, because they relinquish some rights to it by virtue of entering into the employment relation. Neither an employer nor an employee, therefore, can be said to own the information in a company’s personnel files. Such information is simply not property in the usual sense, unlike other kinds of data gathered by corporations. It is necessary, therefore, to develop a conceptual model for personal information other than that of ownership.

## 6.4.4: Gathering Information



Justifying the means used to gather information, which is the fifth issue, involves a different set of considerations. Use of certain means may violate an employee’s right of privacy, even when the information gathered is of a kind that an employer is fully justified in possessing. Examples of impermissible means are polygraph testing and pretext interviews. (Pretext interviews are inquiries made under false pretenses, as when an employer seeks information from an applicant’s family while posing as a market researcher.) Even if employers are justified in asking certain questions on a job application, they are not, for that reason, justified in using a polygraph machine or a pretext interview to verify the accuracy of a person’s responses.

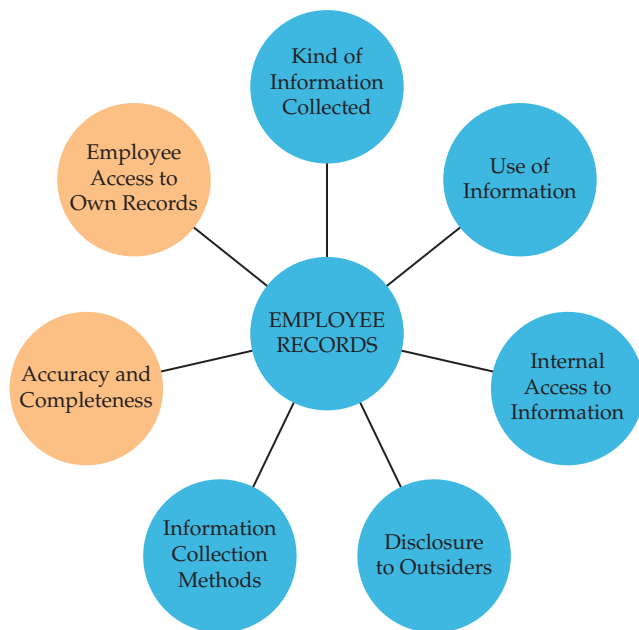
A major consideration in evaluating the means used to gather information is whether less intrusive means are available. In general, less intrusive means are morally preferable to those that are more intrusive. Employers are justified in seeking information about drug use by employees in the workplace, for example, but such means as searches of lockers and desks, hidden cameras in rest rooms, random drug tests, and the like are not justified when sufficient information could be gathered by less intrusive means, such as closer observation of work performance and testing only for cause. (Some means are not justified, of course, even if less intrusive means are not available. Hidden cameras and random drug tests are possible examples.)

What makes some means more intrusive than others depends on several factors. Such practices as conducting strip searches and watching while a urine sample is produced involve an affront to human dignity. An objection to constant monitoring, personality tests, and the use of polygraph machines is that they collect more information than

is necessary and that they collect it indiscriminately. Honesty tests, for example, often inquire into personal habits and interests, family relations, and sexual adjustment—matters that are extraneous to the ostensible purpose.<sup>55</sup> Improperly administered polygraph tests can easily become “fishing expeditions,” which result in the revelation of information that an employer is not justified in having.

Another reason why some practices such as monitoring and surveillance by hidden cameras and polygraph testing are unusually intrusive is that they deprive persons of an opportunity to exercise control over how they appear to others, which is essential for being an autonomous individual. An employee who is unaware of being observed, for example, might be unwittingly led to reveal facts that he or she would otherwise keep from others. George G. Brenkert argues, very perceptively, that because a polygraph machine measures physical characteristics such as breathing rate, perspiration, and blood pressure over which we have little or no control, it “circumvents the person” and undercuts the “way by which we define ourselves as autonomous persons.”<sup>56</sup> As a person, one can shape how one appears to others and create an identity for oneself. A machine that registers involuntary responses denies people the power to do that.

### 6.4.5: Accuracy, Completeness, and Access



The last two issues are concerned primarily with matters of fairness. If the information in personnel files and other corporate databases is going to be used to make critical decisions about wage increases, promotions, discipline, and even termination of employment, then it is only fair that the information be as accurate and complete as possible and that employees have access to their personnel files so

that they can challenge the contents or at least seek to protect themselves from adverse treatment based on the information in them.

Employers who maintain inaccurate or incomplete files and deny employees access to them are not invading the privacy of their employees, as the concept of privacy is commonly defined. What is at issue is not the possession of personal information by an employer but its use in ways that are unfair to employees. The right that employers violate is a right of fair treatment, which is not the same as a right of privacy. Still, because these issues are involved in the handling of personal information, they must be considered in devising policies or laws dealing with employee privacy.

Another objection to drug tests and polygraph machines is their unreliability. A number of factors, including the use of prescription drugs and careless laboratory work, can result in false positives, especially in simpler, less-expensive drug tests. Polygraph machines are inherently unreliable because they register only bodily responses and not the mental experience that triggers them. An investigator might conclude that a subject is lying when the responses recorded by the machine are actually due to a different kind of association. One study, in which 14 polygraphers were asked to evaluate the charts of 207 criminal suspects, found that 50 percent of the experts thought that innocent suspects gave deceptive answers and 36 percent of them considered the guilty suspects to be telling the truth.<sup>57</sup> After a review of the studies to date, the U.S. Office of Technology Assessment concluded in 1983 that polygraph testing was useless for screening in pre-employment contexts.<sup>58</sup>

In summary, determining the exact limits of the right of employees to privacy in the workplace requires that we address a number of issues. Questions about four of these issues—those concerning the kind of information collected, the use to which it is put, and the persons both inside and outside the company who have access to it—can be answered largely by appealing to the notion of a legitimate purpose. The issue of the means used to gain information involves different questions about whether some means are inherently objectionable and whether others are objectionable because less-intrusive means are available. Finally, the remaining issues involve the fair treatment of employees, which is not, strictly speaking, part of a right of privacy but is still related to the handling of personal information.

## 6.5: Big Data Analytics

**6.5 Describe how big data analytics enables companies to profile and target consumers and the potential ethical issues with this process**

Concerns over consumer privacy have been heightened in recent years not only by increased use of the Internet but

also by data analysis. Common, everyday activities such as shopping online, buying groceries with a store's discount card, and using a fitness app on a mobile device create information trails that are extremely valuable, especially to marketing firms. Access to this trove of information has improved the ability of companies to identify consumers, understand their needs, and anticipate their purchasing behavior. Privacy advocates and regulators have begun to scrutinize the ethical issues raised by the activities of the companies that specialize in data collection and analysis.

*Big data analytics* refers to a process that merges large sets of consumer and other data with information technology in an effort to make predictions, especially about human behavior.<sup>59</sup> The emergence of big data has been accelerated in recent years by two factors.

- First, the Internet provides a platform on which almost every decision made by individuals can theoretically be recorded and archived. Consumer purchases, online searches, and ordinary communications, as well as interactions with government agencies, take place today through the Internet, and the resulting data, due to their digital form, can be stored and accessed much more easily than was possible in the past.<sup>60</sup>
- Second, an increased ability to analyze this growing amount of data provides greater opportunity to discover behavioral patterns than in the past and, on this basis, to make predictions about future wants and actions. Sophisticated software algorithms use many different sources of information to make predictions about all sorts of commercial interactions, from what products are displayed on someone's computer screen while shopping online to whether someone is an unacceptable credit risk. Online advertisers can tailor their marketing efforts based on data-driven predictions about their potential to respond.

data with larger databases which identify and profile individuals. Once users are identified, site owners can share the information derived from cookies to form more complete profiles in a process known as "cookie synchronization."

Today, it is common for commercial sites to use third-party data-tracking companies, called "ad networks," which collect and combine users' data to facilitate the sale of advertising space. Ad networks use special digital "beacons," which are more sophisticated than simple cookies. Whereas cookies store data on an individual's computers, beacons are graphic signals on websites that, with the aid of cookies, can track a users' clicking, typing, and browsing behavior *throughout* the Internet.<sup>61</sup> This technology provides the network with a constant stream of data for analysis. Ad networks can also instantaneously match the advertisements that appear on a company's website with a particular individual's profile, drawn from the beacon. This technology explains why an individual searching a certain topic online will curiously find an advertisement or product recommendation related to that search on a completely different website.

Ad networks not only share or sell the collected online data with other companies but they also collaborate with so-called data "aggregators" or "brokers," which specialize in large-scale data collection and analysis. These companies enable marketers to tailor their efforts by providing three types of services.<sup>62</sup> Use Figure 6.2 below to learn what these services are.

The strength of data aggregators is their ability to merge and integrate data from a variety of public and private sources. They combine consumer data—often collected or purchased through online means—with more traditional sources of data, such as demographic and geographic information available through the Census Bureau, birth records, real estate transactions, in-person sales, criminal prosecutions, court decisions, motor vehicle records, and, sometimes, credit history. This integration of online and off-line data

### 6.5.1: Data Collection

The most common method for obtaining information covertly is the installation of a "cookie," which is a file placed on a user's hard drive that recognizes a repeat user and stores information from past visits. Cookies provide the site owner with "clickstream" data about what pages are visited and how much time is spent on each one. Because cookies identify only a user's computer (by tagging it with a unique number), this tool is considered to preserve anonymity. However, personal information can be obtained by combining cookie

**Figure 6.2** Services Offered by Data Aggregators

Sell Access to Data	Offer Consulting Services	Offer Risk Mitigation Services
<p>Aggregators sell access to special subsets of data that facilitate targeted marketing and sales. For example, companies can purchase</p> <ul style="list-style-type: none"> <li>• sets of e-mail addresses that fit certain demographic, income, and geographic characteristics, in order to target online solicitations; and</li> <li>• the off-line data held by aggregators, to advertise specific products to consumers while they are online or are using mobile devices.</li> </ul>	<p>Aggregators typically offer consulting services to help companies analyze their own customer information and develop new marketing strategies. Aggregators are uniquely positioned to understand the nuances of different consumer segments based on countless variables.</p>	<p>Aggregators can harness the power of their data to offer "risk mitigation" services that help other companies, such as financial services firms, detect consumer fraud. Aggregators sell information technology platforms to help clients verify that the information provided on loan applications and insurance claim declarations is consistent with other public and non-public information.</p>

holds the prospect for developing a much more refined identity profile of individuals. The Federal Trade Commission (FTC) reports that data aggregators collect and store information on virtually every household in the United States. One of the aggregators recently studied by the FTC holds 700 billion “aggregated data elements,” an estimated 3,000 pieces of data for nearly every consumer in the United States and access to information covering 1.4 billion consumer transactions.<sup>64</sup>

The work of data aggregators provides consumers with tangible benefits. Their services customize marketing experiences that can improve accessibility and communication between companies and their customers. Aggregators play an instrumental role in helping companies mitigate fraud committed against unsuspecting consumers. Consumers also benefit from innovative product placement and development that detailed marketing analysis can provide. At the same time, however, the methods employed by aggregators to analyze data archives give rise to concerns regarding the autonomy of individual consumers.

### WRITING PROMPT

#### Benefits of Data Collection

Decide whether you agree that data aggregators perform valuable services. In your opinion, which of their three main services provides the greatest benefit to businesses or individual consumers? Explain whether you think this service is worth some loss of privacy.

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## 6.5.2: Ethical Issues with Big Data

Criticisms related to big data analysis by ad networks, data aggregators, and similar operators in the digital marketplace focus on three separate but related issues: the transparency of data analysis, the business practices of data aggregators, and the loss of privacy by consumers.

1. *Lack of Awareness.* First, some industry observers argue that the most significant ethical issue with big data analysis is that few people are aware that it is taking place. With the exception of information related to credit history and creditworthiness, which are heavily regulated, the collection and distribution of “big data” occurs without much legal oversight. The technology used to mine existing data and uncover new sources is used without the knowledge of those most directly affected. This lack of knowledge means that individuals cannot take steps to protect their personal information and prevent it from being collected or distributed.<sup>65</sup> More importantly, consumers have little knowledge of how their personal information is being analyzed or of how this analysis is being put to use.
2. *Difficulty of Protection.* Second, even if consumers had extensive knowledge about how their personal information was being collected, analyzed, and utilized, they could not easily use this knowledge to protect their privacy. Data aggregators do not work alone. They share and sell data among themselves and obtain information from ad networks with which they are affiliated. Ad networks, in turn, use data compiled by aggregators to target advertisements across websites and mobile devices. This free flow of data between different companies makes it difficult for consumers to protect their personal information by “opting out” with one aggregator. Opting out is a common method of protecting privacy, whereby a subscriber, for example, requests that a magazine not share mailing information with outside parties. This method would be effective only if opting out were effective with all aggregators. This point has prompted some commissioners of the FTC to propose regulations that would require aggregators to streamline the process of opting out of the storage and sale of personal information.<sup>66</sup>
3. *Loss of Privacy.* Third, the large-scale data compilation and analysis performed by data aggregators does not simply amount to the possession of discreet information about an individual. It creates a *whole* picture of an individual’s identity, encompassing an array of factors across every dimension of life. Seemingly small and innocuous features of daily activity are combined by data aggregators to produce a well-developed, but possibly inaccurate, identity of an individual for others to know.<sup>67</sup> Potential violations of individual privacy thus occur, not because companies possess specific bits of data about a consumer but because they form a holistic picture of a consumer’s personal identity. The whole identity of an individual reveals much more than the individual pieces from which it is made and thus constitutes a more significant invasion of privacy.

The potential loss of control over one’s whole identity can have negative consequences. Data aggregators can categorize individuals into marketing segments that can be used differently by different companies.<sup>68</sup> An individual who has a history of regularly shopping at a drug store, is registered with a website providing medical information, and frequently searches the Internet for information on the topic of high cholesterol might easily be categorized by a data aggregator as someone with an interest in heart disease. Such a person might welcome targeted advertisements for products that improve heart health. An insurance company, however, could conceivably use this information to deny this person a life insurance policy.<sup>69</sup> Beyond the problems of categorization, the analysis of large amounts of data also holds the prospect of “de-anonymizing” the Internet.<sup>70</sup> With enough information and analyzing capability, it

might become impossible, in the future, for anyone to go online without that person's identity being known.

### WRITING PROMPT

#### Privacy Awareness and Choices

Describe the extent to which you allow businesses to collect and use your personal information, and explain whether you made conscious choices to do so. Why do so many consumers have and use store discount cards? And why do they allow websites to use cookies and collect information about their preferences? What are the challenges facing consumers in deciding how and when to "opt out" from online promotions or tracking by third parties?

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## 6.6: Using the Internet

### 6.6 Analyze the ethical issues associated with collecting and using information about consumers online activities, and the adequacy of the rules and principles created to protect Internet privacy

The explosive growth of the Internet as a consumer marketplace, as well as an online library, is a benefit to consumers and businesses alike. The success of websites depends crucially on the collection of information. One reason is that anonymous sales with cash are not possible. Furthermore, sites that offer free content depend on advertising, and advertising space is much more valuable if it can be tailored to individual users. However, the collection and utilization of information on the Internet appear to pose threats to users' privacy. So we need to ask the following questions.

- First, what is the danger? What harm, if any, is done by websites collecting information, or are any rights violated?
- Second, given the need for government regulation or industry self-regulation, what standards should be applied, and what should be the goal in setting standards?
- Finally, by what means should these standards be implemented?

A variety of organizations have already been formed to offer resources for developing privacy policies and to certify compliance by awarding seals of approval.

#### 6.6.1: Information Collection

What harm, if any, is done by websites collecting information? Are any rights violated?

Individual consumers experience the Internet primarily through a few large companies that provide an array of opportunities for online interaction. Internet service

providers (ISPs), Internet content providers, and social networks effectively shape how communication and commerce takes place in the online environment. Other websites and online retailers are profoundly affected by the presence of these large companies.

Internet content providers, such as Google and Yahoo, play the most significant role in collecting and utilizing information by offering free specialized services, including e-mail, file storage, blog and video hosting, mapping services, social networks, mobile device "apps," and online software. Google has pioneered technology for better understanding its users through the seamless integration of its many Internet services. After logging on to Google's e-mail service, Gmail, users can move easily to Google's Internet search, file storage, and photograph hosting services, among other possibilities. The ease of using Google's services enables the company to build an identity profile of users by analyzing their activity across different platforms, and this profile is used to target advertising, which supports Google's "free" services. This basic arrangement has prompted some observers to underscore that while Google's services are free, they are essentially financed by the collection of personal information.

#### What information do users give up in exchange for Google's services?

Google's information collection capability gives rise to some unique challenges. Consumers expect some of Google's services, such as e-mail and file storage, to provide users with full control over their personal information. It was recently disclosed, however, that Gmail users' e-mail messages were being mined for data that were subsequently used to target advertisements on Google's search engine.<sup>71</sup> Google has maintained that it does not tie this data to particular users and only analyzes e-mail messages for aggregate information that can help refine its ad placement technology. Google gave a similar response when users learned that its Android mobile device operating system has built-in technology for assigning unique device identifiers that permit the tracking of individuals' geographic location.<sup>72</sup> Google noted that users can always opt out of the device identification process and that device identifiers are never tied to particular users' identities, only to particular devices.

Expectations regarding information collection are less straightforward with other Google services. Users generally understand that music downloads on Google's media service, Google Play, and video selections on YouTube are followed just like many commercial movements on the Internet. Still, Google faces continued scrutiny from privacy advocates who argue that even when users elect not to be tracked, Google has circumvented users' privacy settings with new information technology.<sup>73</sup> Google instituted a unified privacy policy in early 2012 to respond to a suit by the FTC and to allay public concerns that the company's disclosures about its methods of information collection across different services were incomplete and misleading.<sup>74</sup>



Social networking sites have also created unique problems for information collection on the Internet. The most notable challenges for privacy protection have come from Facebook, which allows individuals to share their lives online. Facebook users create an individual profile page, which displays personal information such as e-mail addresses, telephone numbers, biographical information, birthdates, educational background, employment information, and current activities. At the heart of Facebook's platform is the ability of users to accept other users as "friends" and thereby build their personal social network. Friends can observe what is posted on each other's profile pages and follow the site's "News Feed" function, which aggregates information about the user's social networks. Friends are also able to comment on or "like" each other's posts and profile page displays.

### What are the main criticisms of Facebook's privacy policies?

Profile pages in Facebook are publicly accessible by default. However, users can adjust the site's privacy settings to restrict access. These privacy settings have been widely criticized, though, for their complexity and lack of transparency.<sup>75</sup> Criticism has focused mainly on the possibility that information can be viewed by an unauthorized user's social network when the privacy settings were improperly set. Critics argue further that Facebook's settings permit this possibility because the privacy controls are difficult to understand and operate.<sup>76</sup> In response to these criticisms, Facebook has periodically revised its privacy policies as well as the graphic interfaces used to control personal information.<sup>77</sup>

These problems exist because social media sites, like the providers of online content and other services, earn money by selling advertising space based on the information it collects about its users. The information gathered about a user, the user's friends, their preferences, and the like enables Facebook, for example, to produce very sophisticated predications about individuals' consumer behavior. This unique ability is attractive to companies that are looking to target specific products to a precise consumer segment. The more information users keep private, the less information Facebook has to understand what its users prefer and hence to target its lucrative advertising.

Facebook's powerful presence on the Internet raises other problems related to information collection. Commercial and media websites routinely utilize registration protocols that are integrated with Facebook so that a user's login credentials can be used as an identity marker on other sites. This feature not only permits users to share information with their friends on Facebook but also allows Facebook to collect data about a user's activity away from Facebook's own site. In 2007, Facebook launched its "Beacon" program, which allowed partner sites to embed special software code that would "broadcast" a user's activity on these other sites to the user's friends when he or she was logged on to

Facebook.<sup>78</sup> In response to users' concern, Facebook eventually ended the Beacon program and replaced it with a more transparent approach whereby partner sites have access to information about a user's activity only with the user's consent. Mobile device apps now work in a similar manner.

### WRITING PROMPT

#### An Acceptable Trade-Off?

Why are so many individuals concerned about the way that Google, Yahoo, Facebook, and other Internet companies gather and use information about online activities? How might the online experience change if personal information were no longer collected and used in the same ways?

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## 6.6.2: Ethical Issues with Internet Use

Is there a need for government regulation or industry self-regulation? Although consumers may feel a lack of privacy when browsing the Internet, is this feeling well-grounded?

Scott McNealy, the chairman and CEO of Sun Microsystems, once remarked, "You have zero privacy anyway. Get over it!"<sup>79</sup> Much of the information compiled is publicly available; the Internet only makes its compilation easier and cheaper than in the past. Store owners, if they wish, could follow consumers around to see what merchandise they examined. Computers do not observe us without our knowledge or intrude into our private lives the way psychological tests or hidden cameras do. The Internet is arguably a public arena, so being online is like walking and talking in the town square. The use to which the information is put is primarily to sell us something. Although fraud is a serious concern, we seek mainly to avoid the annoyance of advertising on the Internet.

However, if privacy is defined as control over personal information or the dissemination of personal information without our consent, then many of the practices of Internet companies violate our rights. This position assumes, though, that we "own" the information about ourselves and thus have a right of control. We give up a great deal of information in order to enjoy the benefits of Internet commerce, and so perhaps some loss of privacy is a trade-off that we voluntarily make. So, following Scott McNealy's advice, should we "get over it"?

**TWO PROBLEMS** The noted expert Lawrence Lessig, in *Code and Other Laws of Cyberspace*, raised two problems that are unique to computers and the Internet.<sup>80</sup>

1. *Confining Profiles.* One risk for Lessig is that our initial contacts with information gatherers form a profile of who we are, and this profile will fit us into a particular mold, which may not be accurate to begin with

and may inhibit our ability to change and grow. Lessig writes, “The system watches what you do; it fits you into a pattern; the pattern is then fed back to you in the form of options set by the pattern; the options reinforce the pattern; the cycle begins anew.”<sup>81</sup> If we develop by selecting from the options available to us, then the choice of options is critical. In life apart from the Internet we can always seek out new options, but to the extent that we are bound on the Internet by the options presented to us, our possibilities for growth are limited.

2. *Threat to Equality.* Lessig’s second risk is that information collection by computers, especially on the Internet, could undermine the traditional American value of equality. The American Revolution was in part a rejection of European society in which innumerable distinctions of rank divided people. According to Lessig, “An efficient and effective system for monitoring makes it possible once again to make these subtle distinctions of rank. Collecting data cheaply and efficiently will take us back to the past.”<sup>82</sup>

**Example:** By means of frequent flyer programs, airlines identify their better customers and offer them special treatment. Companies with 800 numbers recognize the telephone numbers of favored customers and put them at the head of the queue. As a result, some people suffer a form of discrimination in which they do not get a flight on standby or endure long waits on the telephone.

Businesses have always provided better service to select customers, but any discrimination was limited by the cost of the information. Lessig observes, “Whereas before there was relative equality because the information that enabled discrimination was too costly to acquire, now it pays to discriminate.”<sup>83</sup>

**THREE RESPONSES** Neither of these two problems involves privacy per se; the first affects autonomy, the second, equality. Moreover, the effect may be slight and insignificant. Perhaps concern about information gathering on the Internet should be based on what we want to achieve or avoid. Here, three responses can be identified.<sup>84</sup>

1. The first response is made by those who worry about a “dossier” society, in which every facet of our lives is available to those with power, and thus want strict limits on the kinds and amounts of data collected and on the availability of these data. This approach would require external regulators to develop rules governing what information could be acquired and used, if at all, by businesses and Internet companies.
2. In the second response, those who view personal data as a kind of property that can be “traded” in a market for certain benefits want to ensure that consumers do not trade too cheaply and that this valuable commodity

is fairly priced. In the view of this camp, personal information is currently too “cheap” and hence is being overutilized. This approach would enable consumers to make decisions about whether their information can be acquired and, if they so choose, to receive reasonable benefits in exchange for providing their personal data.

3. The third, and dominant, response comes from people in industry, government, and public interest groups who want to balance people’s concerns about privacy—well-founded or not—with the growth of the Internet as a consumer marketplace. They seek to provide consumers with a voice in the development of this important commercial medium. The danger is that the Internet will firmly fix some practices before the public is aware of what is happening. Their goal is primarily to prevent the most egregious abuses by developing standards or principles that safeguard consumers.

### WRITING PROMPT

#### Paying for “Free” Online Services

Suppose that individuals had the option of paying a fee to stop the online collection and use of their personal information. How might this work? Why do some believe that this is a fair exchange and possible solution to the privacy issues with Internet companies? What does this suggest about who owns the information gathered through online activity?

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## 6.6.3: Protecting Privacy

Given the need for government regulation or industry self-regulation, what standards should be applied? What should be the goal in setting standards?

These three responses have resulted in the development of specific rules for privacy protection in both the United States and the European Union at different levels of government. In addition, a generally accepted set of principles that underlie these rules has emerged.

**PRIVACY RULES** In 1972, the U.S. Department of Health, Education, and Welfare developed guidelines for its own handling of information called “fair information practices,” which formed the basis for much subsequent action. The FTC has also attempted to protect Internet privacy by enforcing various consumer-protection laws. In 1980, the Organization for Economic Cooperation and Development (OECD) adopted a set of guidelines that underpin most international agreements and self-regulatory policies of multinational corporations. The European Parliament adopted the European Union Privacy Directive, which took effect on October 25, 1998. This law binds not only member

countries but also nonmember states doing business in the European Union. Recently, the EU's Data Protection Directive has been interpreted as giving citizens the "right to be forgotten," which requires organizations controlling the online dissemination of an individual's personal information to delete anything that is outdated, irrelevant, or excessive if the individual in question makes a formal request.<sup>85</sup>

Although many American laws address various aspects of Internet privacy, the United States has preferred a piecemeal legal response instead of adopting an omnibus piece of legislation like the EU Privacy Directive. Some states have crafted legislation to regulate the type of interaction between individuals and commercial websites. In 2003, for instance, the state of California codified the Online Privacy Protection Act, which requires operators of commercial websites to post clear policies regarding the personal information that they collect from Internet users. The law was amended in 2013 to further require website operators, including companies that design so-called mobile apps, to disclose how they collect information when users elect not to be monitored while using their web browser. The law also mandates that commercial sites clearly stipulate whether they share personal information with third parties, such as online marketing firms.<sup>86</sup> Principles of privacy on the Internet have also been developed by industry associations, such as the Online Privacy Alliance (OPA), and public interest groups, most notably the Electronic Privacy Information Center (EPIC).

**PROTECTION PRINCIPLES** Despite this great diversity of sources, a remarkably similar set of principles has emerged. The FTC list of five principles is representative of the many documents on Internet privacy.

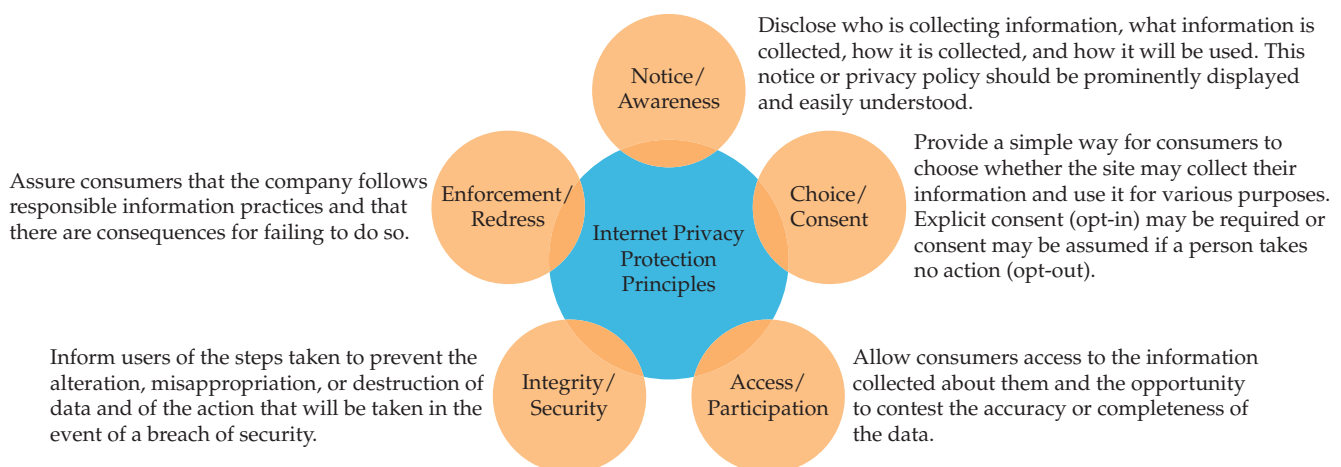
1. *Notice/Awareness.* Disclose the identity of the collecting party, the information collected, the means for collecting it, and the uses to which the information will be put. This notice usually consists of a privacy policy that should be

prominently displayed and easily understood. Ideally, the home page and every page that asks for information should include a link to the policy. Notice should also be given if the privacy policy is not the same for all linked sites or if data will be shared with other parties with different policies.

2. *Choice/Consent.* Provide a mechanism for choosing whether to allow information to be collected. The mechanism may either require explicit consent (opt-in) or assume consent if a person takes no action (opt-out). One could choose to permit the collection of some information (name and address, for example) but not other (e.g., medical information), or one could consent to some uses of information (to select banner ads, for example) but not others (e.g., providing information to a third party).
3. *Access/Participation.* Allow consumers access to the information collected about them and the opportunity to contest the accuracy or completeness of the data. The right of access may exclude information that a company collects from sources other than the website and any results from processing website data.
4. *Integrity/Security.* Inform users of the steps taken to protect against the alteration, misappropriation, or destruction of data and of the action that will be taken in the event of a breach of security. Also, maintain information so that it is accurate and up-to-date.
5. *Enforcement/Redress.* Assure consumers that the company follows responsible information practices and that there are consequences for failing to do so. Consumers should also have some means for resolving disputes and for receiving an appropriate remedy. One way to ensure enforcement and redress is by contracting with an organization that monitors and certifies the information practices of websites.

Use Figure 6.3 below to review these principles and recommended practices for businesses.

**Figure 6.3** FTC Principles for Protecting Consumer Privacy Online



Although substantial agreement exists on these five principles, much depends on their interpretation and implementation. In particular, how stringently should the principles be interpreted, and what are the most effective and efficient means for implementing them? Other questions include the responsibility of Internet companies. For example, Yahoo! was criticized for revealing to the U.S. Navy the identity of a sailor who used the pseudonym “Boysrch” in gay chat rooms. (The navy used this information in an attempt to oust the sailor from the service for homosexuality.) The principles do not specify whether they apply to information that websites acquire from sources other than the Internet, which are then aggregated with data obtained from users. The most contentious issues are whether the weaker opt-out provision is satisfactory in most instances and in what cases, if any, opt-in ought to be required. Finally, few proposals have been developed for handling enforcement and redress.

### WRITING PROMPT

#### Best Privacy Practices for Businesses

How could the FTC’s principles for Internet privacy, if correctly followed, be amended to more adequately protect consumers? Explain any changes that you would make and why you think they are necessary.

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**IMPLEMENTING PRINCIPLES** Principles are of little value if they cannot be successfully implemented, and the Internet presents unique challenges for implementation. Its decentralized, democratic structure makes centralized, authoritarian approaches ineffective, as does its global reach. Because the web is worldwide, so too must be any successful regulatory scheme. Although government regulation, as represented by the EU Privacy Directive, creates a powerful incentive to protect privacy, laws must still grapple with the difficult question of the appropriate means. In considering the problem of protecting Internet privacy, we must ask:

Who should be involved in implementing privacy standards or regulations? And second, what means should be used?

Obviously, the principal parties are Internet firms (websites and ISPs), computer companies (both hardware and software suppliers), software engineers, industry associations, governments and regulatory agencies, public interest groups, and, of course, individual users. The main approach to date has focused on government regulation and self-regulation by the industry, designed in large part to prevent further intrusion by government. Self-regulation has largely taken the form of developing privacy policies

and, in some instances, creating the post of chief privacy officer (CPO) to direct company efforts. In this task, websites have been aided by public interest groups that offer resources and certification. Organizations, such as TRUSTe and BBBOnline (a service of the Council of Better Business Bureaus), monitor a firm’s compliance with its privacy policy and award a seal that can be displayed on its website.

The most effective solution to a problem created by runaway technology might very well be more technology. We can protect privacy through both *formal* and *material* means.<sup>87</sup> Regulation and certification as described earlier utilize rules or norms that are designed to influence behavior. Such formal means can be supplemented with changes in material conditions that prevent certain kinds of behavior. Although we need laws against theft (formal), we also protect property with locks (material). The suggestion, then, is that we develop technology that will enable Internet users to protect their privacy to the extent they desire. To be effective, this technology must be usable by even the most unsophisticated in order to overcome the problem of the “blinking twelve” (which refers to the number of people who cannot even set the clock on electronic devices).

A material solution consists in the development of various privacy-enhancing technologies (PETs). Among such means are services that permit “proxy surfing” by hiding the identity of the user’s computer and remailers that forward e-mail stripped of any identifying markers. Cookie-management software exists that can block or disable cookies. Intel caused controversy by encoding a unique Processor Serial Number (PSN) in its Pentium III processor, but the company later offered software that would enable a user to suppress this number.<sup>88</sup> These PETs are likely to be used, however, only by very sophisticated users, and so we encounter the “blinking twelve” problem.

Arguably the most straightforward option is not a PET but simply web browsers and mobile apps that have their settings automatically set to a “do not track” setting. Some Internet browsers, such as Mozilla’s Firefox and Apple’s Safari, already claim to offer easy-to-use settings to avoid being tracked by websites and ad networks.<sup>89</sup> Advocates of this option recommend that the “do not track” setting be designed as the default option, which could eliminate any potential oversight by users who lack a full understanding of the Internet and the terminology associated with online tracking. Along similar lines, Lessig suggests the creation of an electronic butler or a Cyber-Jeeves. This software program would allow a user to answer a few questions about the desired features of a website’s privacy policy and then determine whether sites to be visited fit the user’s preferences. Such software is the goal of the Platform for Privacy Preferences Project (P3P), which is being conducted by the World Wide Web Consortium. If installed on most personal computers, a Cyber-Jeeves would force websites to adopt the privacy policies that the majority of Internet users desire.

## Conclusion: Privacy

Although privacy is a relatively recent concept—dating in American law to the 1890s—public concern is clearly increasing, primarily in response to privacy-invading technologies. The problems facing employees, consumers, and Internet users are similar, as are the solutions. There is greater agreement, however, on the ends than on the means, but even the ends are in dispute. Americans say that they value privacy, and yet they give up a great deal for convenience and material gain. Without question, the technologies that threaten privacy have brought us many benefits. Finding the right means is a great challenge to business firms that must meet employee and consumer expectations as they utilize new technologies. More than many other ethical problems in business, protecting privacy requires a coordinated solution involving many parties. Until a solution is found, though, developing and implementing privacy policies will remain a challenge for business and society.

### End-of-Chapter Case Studies

This chapter concludes with three case studies.

In each of the three cases, the power of technology to enable the collection of personal information raises ethical questions about the challenges this power poses to individuals' privacy. Although employees are probably well advised not to assume that any communications on company-owned devices is private, should employers have an unlimited right to monitor these communications and use them as a basis for employee discipline ("Privacy of Text Messages")? The "leaks" at Hewlett-Packard were unusual in occurring on the board of directors, and technology was used by the chair of the board in an arguably unethical manner to identify the leaking board member. "Information Handling at ChoicePoint" explores both the social benefit of information collection companies and their responsibility in protecting the information they gather from security breaches.

### Case: Privacy of Text Messages

In 2002, Sergeant Jeff Quon, a police officer with the city of Ontario, California, learned that his supervisors

had audited his use of a department-issued pager.<sup>90</sup> The text messages that Quon had sent and received on this pager significantly exceeded the monthly allotment of 25,000 characters that was allowed in the department's mobile service contract. The department did not prohibit employees from using their communication devices for personal text messaging. However, employees were told that personal use should not be excessive and that they were expected to pay for usage beyond the allowable messaging limits. The rationale for the audit was straightforward: It was part of a larger effort by the Ontario Police Department to determine the necessary level of mobile service for employees' job-related activities.<sup>91</sup> This effort was undertaken because the department chief thought that it was unnecessarily burdensome for the department to collect "overage" fees from employees who used their department-issued devices for personal use.

The audit revealed that Quon had sent personal text messages while on duty and that some of these messages were of a sexually explicit nature.<sup>92</sup> These personal messages had been sent to his wife, Jerilyn Quon, and also to a girlfriend, April Florio, an Ontario Police Department dispatcher with whom he was having an affair. Some personal messages were sent to another sergeant in the department, Steve Trujillo. As a result of the audit, Quon was "disciplined" in accordance with the department's personnel policies for "pursuing personal matters while on duty."<sup>93</sup>

The Ontario Police Department was able to obtain records of Quon's text messages through the city's contract with a local service provider, Arch Wireless, which archived the messages exchanged between Quon, Florio, and Trujillo on their employer-issued pagers. From the transcripts of Quon's text messages provided by Arch Wireless, Ontario Police Department investigators could easily determine the recipients of the messages, the time the messages were sent, and the content of the messages.<sup>94</sup> In their report of the audit, the Ontario Police Department redacted the content of all messages that Quon had sent while off duty.<sup>95</sup>

In 2003, Sergeant Quon, along with his wife, Jerilyn Quon, April Florio, and Steve Trujillo, filed suit in federal District Court claiming that the Ontario Police Department and the City of Ontario had violated his rights under the Fourth Amendment to the U.S. Constitution by examining his text messages. The Fourth Amendment protects the

right of citizens to “be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures.” Quon’s suit maintained that the Fourth Amendment protected public employees against unreasonable searches and seizures at work because their employer is a unit of government, subject to the limitations set forth in the Constitution.

The Ontario Police Department maintained in court documents, however, that Quon had no expectation that the text messages sent on his pager would be treated as private information, subject to Fourth Amendment protection. Even though there was no explicit policy regarding mobile devices, Quon was notified in writing by the department that the City of Ontario’s “Computer Usage, Internet and Email Policy” was applicable to his department-issued pager.<sup>96</sup> This policy clearly stated that use of city-owned equipment and communication through the city’s e-mail server were subject to auditing and that all employees were expected to limit their use of city-owned equipment and the e-mail system to work-related matters.

Quon was also notified during an employee meeting that messages sent and received on department-issued pagers were considered e-mail messages for the purposes of the city’s electronic communications policy. The department further claimed that Quon was issued a pager specifically for use as a member of the department’s SWAT team. This highly specialized group of police officers was given pagers for use when other forms of communication were unavailable. These facts led the District Court to rule in favor of the Ontario Police Department, noting that, in the absence of an expectation of privacy, Quon’s Fourth Amendment protections were not violated.

The court ruling was complicated by the fact that the supervising lieutenant told Quon, prior to the audit, that messages over the standard limit would not be reviewed if Quon paid for the overage fees. Quon subsequently claimed in Federal Appeals Court that he relied upon this informal assurance and also believed that the policy of permitting personal use of the pager conveyed an expectation of privacy. He argued, further, that accessing the content of his text messages was unnecessary if the only purpose of the audit was to determine the allotment of work-related messaging. The amount of official text messaging could have been assessed, for example, through employees’ own record-keeping or an examination of the time and recipient of the messages, rather than from the content of the messages themselves.<sup>97</sup> The Appeals Court was persuaded by this argument and overturned the District Court’s ruling, which would stand pending any review by the U.S. Supreme Court.

## SHARED WRITING: PRIVACY OF TEXT MESSAGES

Why did Quon think that the Ontario Police Department violated his right to privacy? Which of the employer’s actions are questionable or unjustified, and why? Why did so many observers think that Quon’s misuse of his department-issued pager made such a difference in this case?

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Plugging Leaks at HP

Hewlett-Packard, a leading manufacturer of computers, printers, and peripherals, takes privacy very seriously. The company proclaims that it “has set the bar high when it comes to privacy” and asserts, “We make privacy protection integral to our business operations.”<sup>98</sup> This high regard for privacy was apparently cast aside in 2006 when HP’s chairwoman Patricia C. Dunn sought to discover the source of leaks to the press from the company’s own board of directors.<sup>99</sup>

In January and February of 2005, when the board was considering the future of then-CEO Carleton S. Fiorina, who was eventually ousted from her position, articles in the *Wall Street Journal* and the *New York Times* reported extensive details of confidential board deliberations. These unauthorized disclosures exacerbated the existing tensions among board members and led some directors to pressure chairwoman Dunn to find the source of the leaks. Later, in January 2006, a news article on the web-based CNET Networks on the strategic plan of HP under its new CEO, Mark V. Hurd, suggested that leaks were still coming from one or more board members. In Ms. Dunn’s view the leaks were doing great harm to the company and had to be stopped.

Because she was a possible subject of suspicion, Ms. Dunn felt that she could not direct an investigation, and so she contracted with a Massachusetts-based firm named Security Outsourcing Solutions, which, in turn, hired a subcontractor, Action Research Group, based in Florida, to do much of the detective work. However, Ms. Dunn was kept apprised of some of the contractors’ operations. The investigators managed to obtain telephone records of several board members and journalists for the *Wall Street Journal*, *New York Times*, and CNET by posing as the individuals in question and requesting copies of their telephone bills, which contained lists of all calls made. This practice is known as “pretexting” because a pretext—a misrepresentation of the identity and purpose of the

requester—is employed to obtain information. In all, the outside contractors analyzed 33 months of telephone calls involving 24 people under investigation and 590 of the people they contacted.<sup>100</sup>

In addition, some board members and journalists were put under active surveillance, and videos were examined for signs of meetings between directors and journalists. In at least one instance, an investigator, posing as an anonymous tipster, sent an e-mail message to a CNET reporter with a piece of Trojan software that was intended to send back information about any addresses to which the message was forwarded.<sup>101</sup> This ruse apparently failed to work, though. HP also conducted a feasibility study for planting undercover agents in the San Francisco news bureaus of the *Wall Street Journal* and CNET in the guise of clerical workers or cleaning staff.<sup>102</sup> There is no evidence, however, that the plan was ever implemented.

The investigation succeeded in identifying the leaker. It was George A. Keyworth II, the longest-sitting HP board member, who had also served as director of the White House Office of Science and Technology Policy from 1981 to 1986 during the Reagan administration. When confronted in a board meeting on May 18, 2006, Mr. Keyworth was reported to have said, “I would have told you all about this. Why didn’t you just ask?”<sup>103</sup> In his defense, he explained that he was “frequently asked by HP corporate communications officials to speak with reporters—both on the record and on background.”<sup>104</sup> He said he often met with reporters to promote the company and denied ever divulging any confidential or damaging information. During the meeting, Keyworth was asked by a majority of the other directors to resign. He refused but later left voluntarily when Ms. Dunn agreed to step down as chair. Another director, Thomas J. Perkins, resigned to protest the way that Ms. Dunn had handled the matter. It was Mr. Perkin’s insistence that the reasons for his resignation be explained publicly that led to the disclosure of the investigation.

In the ensuing uproar, the Securities and Exchange Commission and the U.S. House of Representatives requested information in order to determine whether any laws had been broken or any new regulations were needed. The California state attorney general launched a criminal inquiry in the belief that pretexting violated existing law. Although HP had obtained a legal opinion that pretexting was legal, the opinion of lawyers was divided. To date, Congress has not passed any legislation that explicitly outlaws the practice. Although the California legislature passed and the governor has signed a bill to forbid pretexting, the law did not take effect until January 1, 2007, after the HP investigation.

To the end, Ms. Dunn refused to take responsibility for the investigation or admit that she had done anything wrong. Before a congressional House committee, she declared, “I do not accept personal responsibility for what

happened.”<sup>105</sup> Although she admitted that the investigation “wasn’t implemented well” and that “it looks like there was sloppy work along the way,” she still called it a “noble cause” and said that she had “no choice” but to respond to the leaks.<sup>106</sup> In contrast, Mark Hurd, the CEO, stated, “I am taking action to ensure that inappropriate investigative techniques will not be employed again. They have no place at HP.”<sup>107</sup>

### SHARED WRITING: PLUGGING LEAKS AT HP

Which of the methods employed by Dunn’s hired investigators involved the most serious violation of individuals’ privacy? Which demonstrated the greatest failure to respect the privacy of the individuals under investigation? Why might some think that the investigation would have been more acceptable if it was focused on a company (as when seeking competitor intelligence) rather than individuals?

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Information Handling at ChoicePoint

As the chief executive officer and chairman of ChoicePoint, Derek V. Smith believed that the company’s business of collecting information on virtually every American and providing it to customers was a great public service. He asserted that “ChoicePoint is built on the premise that the responsible use of information will reduce risk and make the world safer and more secure.”<sup>108</sup> However, some critics think that ChoicePoint and the information collection industry as a whole pose great hazards.

### ChoicePoint’s Business

Based in Alpharetta, Georgia, a suburb of Atlanta, ChoicePoint was formed in 1997 as a spin-off from Equifax, the giant credit reporting company. Under Mr. Smith’s leadership, ChoicePoint bought more than 70 information-gathering companies over the next seven years to amass billions of pieces of data on individual Americans. This information included motor vehicle records, credit histories, insurance claims, birth and death certificates, marriage and divorce decrees, criminal actions, civil judgments, and real estate transactions. Among the customers for ChoicePoint’s services were banks, insurance companies, debt collectors, landlords, private investigators, law enforcement agencies, and the federal Department of Homeland Security. By 2004,

the company provided more than 100,000 individual, corporate, and government customers with reports, which generally cost between \$5 and \$15 each and which generated around \$1 billion in annual revenues.<sup>109</sup>

## Benefits and Harms

Aside from generating profits for ChoicePoint and its main competitors, Acxiom and Lexis-Nexis, computerized data collection and dissemination produce many benefits that are expressed in the company's motto, "smarter decisions, safer world." Business transactions are quicker and more secure when both parties know each other. In Mr. Smith's view, easy access to reliable personal information helps restore a lost America in which neighbors in small towns knew each other and could conduct business with confidence.<sup>110</sup> With the advent of centralized computer databases of personal information, the approval of applications for jobs, loans, credit cards, insurance policies, housing rentals, and the like can be done much more quickly than in the past. In addition, ready information enables banks and credit card companies to combat fraud, which benefits consumers by reducing costs. Costs are also reduced when companies use information in ChoicePoint reports to avoid hiring problem employees. Although law enforcement agencies have their own databases, which include nonpublic information gained by eavesdropping and other kinds of surveillance, they can prevent or solve crimes more effectively when they have access to the additional public information offered by commercial firms. ChoicePoint and other private companies are useful to law enforcement and Homeland Security officials because they can collect some information that government agencies cannot because of public sector privacy laws.<sup>111</sup>

These benefits of the data collection industry are offset by some possible harms.

### **What possible harm could come from creating databases of sensitive personal information, such as Social Security and drivers license numbers and credit reports?**

#### **Identity theft**

Many critics point to the contribution of the industry to the problem of identity theft, which claimed 8.3 million victims in 2005 or 3.7 percent of all American adults.<sup>112</sup> Identity theft, which some call "data rape," affects people's sense of security as well as their pocketbook. In addition to incurring out-of-pocket losses, which may include lost wages, legal fees, and the payment of fraudulent debts, victims of identity theft may also encounter delays in accessing bank accounts, denial of credit, harassment from debt collectors, and the hassle of clearing credit records. It is difficult to determine the extent to which identity thieves obtain personal information from data collection companies. A 2005 report found that more than half of all victims did not know how the thieves had

obtained their personal information and that the information in 16 percent of identity theft cases was stolen by family members and acquaintances.<sup>113</sup> Still, the few breaches of security that have occurred at data collection companies result in the unauthorized release of personal information on large numbers of people.

Critics also charge that commercial data collection is a threat to privacy. Most of the information provided by ChoicePoint and other companies is drawn from records in government offices and courthouses, which have long been available to the public. However, people's privacy has been preserved in the past by the fact that the personal information from these scattered sources has been costly and time-consuming to acquire. With the advent of large computers, though, it is possible to make information about individuals readily available in one place for anyone with a legitimate need to know. One consequence of this development is that damaging information, such as an arrest record, may follow an individual throughout life, thereby creating what some critics call a "scarlet letter" society, in which people's transgressions are publicly displayed for all to see. However, defenders of the data collection industry question whether the inability to escape from one's past constitutes a violation of privacy. Mr. Smith argues that there is a big difference between privacy and anonymity. "Yes we have a right to privacy. But in this society we can't have a right to anonymity."<sup>114</sup>

## Security Breaches

In February 2005, ChoicePoint acknowledged that serious security breaches had occurred. The company notified 163,000 people that data thieves, posing as representatives of legitimate businesses, had gained unfettered, round-the-clock access to the company's computerized records.<sup>115</sup> Although ChoicePoint employs sophisticated technology to keep hackers out of its computer system, the thieves exploited gaps in the company's verification procedures to register as customers. At least 800 cases of identity theft were known to have resulted from these data losses.<sup>116</sup> In their defense, ChoicePoint executives argued that the rogue customers were sophisticated enough to get business licenses and other credible documents. However, a report by the FTC concluded that the company was lax in its procedures and had overlooked obvious "red flags."<sup>117</sup> For example, ChoicePoint did not question applications that had incomplete or contradictory information, that listed residences or commercial mail services as addresses and cellular telephone numbers as contacts, and that were sent from fax machines in public locations, such as Kinko's stores. In some instances, the submitted documents showed that the company's incorporation or tax registration had been suspended or cancelled.<sup>118</sup> One information security



consultant observed, “It was a well-known fact back then that ChoicePoint would do business pretty much with anyone who came along.”<sup>119</sup>

Following this acknowledgment of security breaches, ChoicePoint was severely criticized by privacy groups. The human rights organization Privacy International bestowed its 2005 Lifetime Menace Award on the company.<sup>120</sup> The Electronic Privacy Information Center (EPIC) filed a complaint with the FTC and called for a congressional investigation, which was subsequently undertaken. Faced with this outpouring of criticism, Mr. Smith and other ChoicePoint executives were forced to consider their response.

- How should the company deal with the 163,000 individuals whose personal information has been improperly released to data thieves?
- What steps should ChoicePoint take to improve its security and ensure that the personal information of every American is safe?
- And, finally, could the company defend its business model of collecting and disseminating personal information for paying customers?

### SHARED WRITING: INFORMATION HANDLING AT CHOICEPOINT

Compare ChoicePoint’s business with that of data aggregators who focus on gathering and using consumers’ online activities for marketing purposes. Make the case for why someone might believe that the personal information collected by ChoicePoint was more sensitive or private than profiles of online behavior and purchases. How could a company like ChoicePoint better protect its consumer information, given how the security breach in 2005 occurred?

Review and comment on at least two classmates’ responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

### Chapter 6 Quiz: Privacy

# Chapter 7

# Discrimination and Affirmative Action



## Learning Objectives

- 7.1** Explain the meaning of discrimination in employment, the legal distinction between disparate treatment and disparate impact, and the various forms of discrimination
- 7.2** Define how sexual harassment and the distinct forms of sexual harassment constitute acts of discrimination
- 7.3** Apply and contrast arguments against discrimination that are based on utilitarianism, Kantian ethics, and principles of justice
- 7.4** Recommend steps and measures a company can take to help ensure that its hiring and promotion processes are nondiscriminatory
- 7.5** Analyze the various issues, arguments, and problems associated with affirmative action plans and court decisions

### Case: Race Discrimination at Texaco

On November 4, 1996, the *New York Times* disclosed the contents of a secretly recorded conversation in which three senior Texaco executives discussed plans to destroy documents that were being sought in a class-action lawsuit for racial discrimination.<sup>1</sup> Also on the tape were derogatory comments about black employees and ridicule of the company's efforts at diversity. One executive was heard to say, "This diversity thing. You know how all the jelly beans agree." Another said, "That's funny. All the black jelly beans seemed to be glued to the bottom of the bag." To this the first executive responded, "You can't just have black jelly beans and other jelly beans. It doesn't work."

The public reaction was fast and furious.irate Texaco customers threatened to cut up their credit cards. The trustee of a large pension fund with 1.3 million Texaco shares wrote that the taped conversation suggests "a corporate climate of disrespect." Civil rights leaders, including the Reverend Jesse Jackson, threatened a nationwide boycott of Texaco service stations. Three days after the *New York Times* article appeared, Texaco CEO Peter I. Bijour issued an apology, saying, "The statements on the tapes arouse a deep sense of shock and anger among all the members of the Texaco family and decent people everywhere." Less than 10 days later, Tex-

aco abruptly settled the discrimination lawsuit, which had dragged on for two-and-a-half years. The company agreed to pay \$141 million in compensation to 1,350 black employees and to spend another \$35 million for improvements in the diversity program at Texaco.

The lawsuit was filed in March 1994 by 6 employees on behalf of 1,500 salaried African Americans employed by Texaco. Although these employees reported numerous examples of racist incidents, the suit focused on a pervasive pattern of discrimination in promotion and pay. The petroleum industry had never fully shed its "good old boy" culture that prevented the advancement of women and racial minorities, but an industry-wide survey conducted annually showed that Texaco lagged behind every other major oil company. As a percentage of employees in each salary bracket in the survey, blacks at Texaco trailed the competition in every one, and the percentage of blacks declined more sharply than at other companies as the salary brackets increased. Of employees earning between \$51,100 and \$56,900 in 1993, 5.9 percent were black at Texaco versus 7.2 percent at the other major oil companies. In the highest bracket, above \$128,800, only 0.4 percent of the income earners were black compared to 1.8 percent elsewhere. On average, blacks in each job category were paid 10 to 15 percent less than their white counterparts. Promotions were slower in each job category. A study by the

U.S. Department of Labor in 1995 found that it took 6.1 years for minority employees to rise to the position of accountant and 4.6 years for minority employees at the other major oil companies to achieve the same position. Whites who were promoted to assistant accounting supervisor at Texaco took an average of 9.8 years, but blacks in that position had waited 15.0 years for promotion.

The plaintiffs decided to file the suit, *Roberts v. Texaco*, after they discovered striking similarities in the tactics that had been used to prevent their advancement. The lead plaintiff in the suit, Bari-Ellen Roberts, was a pension analyst who had been wooed from Chase Manhattan Bank, where she supervised the Texaco pension account as a vice president. At Texaco, she quickly discovered that she had been hired mainly to improve the racial percentages. She once had a superior evaluation reduced to unsatisfactory because a higher executive had found her “uppity” for openly disagreeing in a meeting. When the position above her in the pension department became open, a white male with no experience in pensions was brought in with the explanation that “Bari will help train him.” Another plaintiff complained that he was assigned less capable staff members, whose poor performance reduced his own evaluation. One member of his staff, a white male, was allowed to report directly to the plaintiff’s superior to avoid reporting to a black.

Widespread discrimination flourished at Texaco despite an explicit company policy and an established diversity program. The booklet “Texaco’s Vision and Values” states, “Each person deserves to be treated with respect and dignity in appropriate work environments, without regard to race, religion, sex, age, national origin, disability or position in the company.” The company had an affirmative action plan that set diversity goals and provided for diversity training. In fact, the idea of different-colored jelly beans was taken from a

diversity training session attended by the executives in the taped conversation.

### **Why do you think Texaco’s company policy and diversity program did not curb discrimination?**

#### **Compare Your Thoughts**

The problem, according to the observers of Texaco’s culture, was the lack of high-level oversight. Implementation of the diversity program was left to middle- and low-level managers, with little guidance from above. Complaints of racist treatment were generally dismissed, and seldom was any action taken against the offenders. Texaco conducted no audits to measure the success of its own affirmative action plan or studies to determine whether its personnel practices discriminated against women or racial minorities. The results of government investigations seldom reached top executives. Promotion was heavily determined by a secret list of “high-potential” employees, which was not formally scrutinized for its possible discriminatory effects. Indeed, no official criteria existed for the inclusion of people on the list—or their removal. (Bari-Ellen Roberts inadvertently discovered after her lowered evaluation that her name had also been removed from the high-potential list.)

The settlement ended Texaco’s legal woes, but the task of changing the corporate climate remained. How should the company spend the \$35 million that was committed to improving diversity? CEO Peter Bijour denied that the programs that Texaco had in place “were flawed in any way.” The solution, in his view, was to expand and improve the initiatives already underway. These efforts included higher goals (but not quotas) for the percentages of black employees, more diversity training, greater emphasis on mentoring and career counseling, an increase in the use of minority suppliers, advertising in black publications, and support for black causes.

## Points to Consider . . .

Many racial and ethnic groups have been subject to discrimination, and the treatment of women by American business constitutes another prominent form of discrimination. Discrimination is not simply a matter of the number of blacks, women, and members of other minority groups who are hired by an employer. In the early 1970s, for example, more than one-half of the employees of American Telephone & Telegraph Company (AT&T) were women, and racial minorities constituted over 10 percent of the AT&T workforce.<sup>2</sup> Women employees were largely concentrated in low-paying clerical and telephone operator jobs, however, and blacks, Hispanics, and members of other racial and ethnic minorities were employed chiefly in unskilled job categories, such as maintenance workers and

janitors. As a result, AT&T was charged with discriminating against women and racial minorities by using sex and race as factors in making job assignments. Eventually, the company agreed to increase the representation of these groups in job categories from which they had previously been excluded.

This chapter is concerned primarily with the steps that can be taken to prevent discrimination and rectify past wrongs. Some of these measures, such as nondiscriminatory hiring and promotion procedures, are widely implemented in the American workplace, but others, especially affirmative action, remain controversial. In order to address the ethical issues in discrimination, sexual harassment, and affirmative action, it is useful to begin with a definition of discrimination in its many forms and a discussion of the ethical arguments against it.

## 7.1: What Is Discrimination?

### 7.1 Explain the meaning of discrimination in employment, the legal distinction between disparate treatment and disparate impact, and the various forms of discrimination

The term “discrimination” describes a large number of wrongful acts in employment, housing, education, medical care, and other important areas of public life. Although discrimination in each of these areas takes different forms, what they have in common is that a person is deprived of some benefit or opportunity because of membership in some group that faces substantial prejudice. Discrimination in employment, which is our concern here, generally arises from the decisions employers make about hiring, promotion, pay, fringe benefits, and the other terms and conditions of employment that directly affect the economic interests of employees. There is nothing unjust about such decisions as long as they are made for reasons that are reasonably job-related, but singling out a person for adverse treatment merely because of that person’s race, sex, or religion, for example, is generally an act of discrimination.

Although discrimination is a form of unequal treatment, not all unequal treatment is discrimination. An employer who shows favoritism in deciding on promotions, for example, is guilty of violating the principle of equality in dealing with employees but not necessarily of discriminating against them. Two further elements are necessary.

- First, discrimination involves decisions that directly affect the employment status of individuals or the terms and conditions of their employment; that is, discrimination occurs in what are generally regarded as *personnel* decisions, such as those involving hiring and firing, promotion, pay, advancement opportunities, and the like.
- Second, the unequal treatment results from prejudice or some other morally unjustified attitude against members of the group to which an individual belongs. In cases of discrimination, individuals are not treated on the basis of individual merit but on the basis of membership in a group.

### 7.1.1: Civil Rights Act of 1964

These two elements—unequal treatment and the basis for it—can be observed in Title VII of the 1964 Civil Rights Act. Section 703(a) reads as follows:

It shall be an unlawful employment practice for an employer—

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual’s race, color, religion, sex, or national origin; or

(2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual’s race, color, religion, sex, or national origin.<sup>3</sup>

Notice that Title VII first describes the kinds of employment decisions that are governed by the statute and then lists five factors—race, color, religion, sex, and national origin—that employers with 15 or more employees are not legally permitted to take into consideration. These factors define groups that are called in law *protected classes*. In subsequent legislation, Congress extended the list of protected classes in order to prevent discrimination against the following groups:

- older people (Age Discrimination in Employment Act of 1967),
- the handicapped (Rehabilitation Act of 1973 and the Americans with Disabilities Act of 1990), and
- pregnant women (Pregnancy Discrimination Act of 1978).

Section 703(e) of Title VII allows exceptions for sex, religion, and national origin when these are a “bona fide occupational qualification [BFOQ] reasonably necessary to the normal operation of that particular business or enterprise.” Race and color are not included in Section 703(e) as a BFOQ and thus cannot be used legally to make distinctions for purposes of employment. The courts have interpreted the BFOQ exception very narrowly, so that employers must show that the qualification is absolutely essential for the conduct of business and not merely useful. When discrimination on the basis of age was barred in 1967, courts ruled that airlines were, nevertheless, legally permitted to force pilots to stop flying at the age of 60 for safety reasons, but a federal appeals court rejected an airline’s argument against male flight attendants on the grounds that the job of reassuring anxious passengers and giving courteous personalized service not only could be performed by men but were also peripheral to Pan Am’s main business of transporting passengers safely.<sup>4</sup>

One of the few cases in which the Supreme Court has held sex to be a BFOQ concerned a rule adopted by the Alabama Board of Corrections excluding women from positions in a maximum-security male prison requiring close contact with the inmates.<sup>5</sup> The majority opinion argued, first, that women employees are likely to be the victims of sexual assaults in a prison characterized by “rampant violence” and a “jungle atmosphere.” Second, the likelihood of sexual assaults would reduce the ability of a woman to maintain order in the prison, which is the main function of a prison employee. The presence of women in a male prison poses a threat, therefore, “not only to the victim of the assault but also to the basic control of

the penitentiary and protection of its inmates and other security personnel.”

Several members of the Court disagreed. It is not clear, they said, that women are exposed to significantly greater risk of attack than men who are employed in the same positions at the prison. Even if a job is more dangerous for some individuals than others, it is less discriminatory to allow individuals to decide voluntarily the degree of risk to assume rather than bar those at greater risk. Also, Justice Thurgood Marshall observed, “It is women who are made to pay the price in lost job opportunities for the threat of depraved conduct by male prison inmates.” A better solution, perhaps, would be to make the workplace safer for women instead of limiting their employment opportunities because of the threatened conduct of others.

### 7.1.2: Disparate Treatment/Impact

Employment policies that do not explicitly involve classifying employees by race, sex, or other impermissible characteristics can still serve to exclude members of these groups in disproportionate numbers. In interpreting Title VII, the courts have generally held that employers are guilty of discrimination in the absence of any intent *when the effects are the same as if there had been an intent to discriminate*. Discrimination is thus not solely a matter of intention but also of consequences. A distinction is made in law between *disparate treatment*, which is discrimination of the first kind, involving an express intention, and *disparate impact*, which is discrimination of the second kind.

A landmark case in discrimination law that illustrates the distinction between disparate treatment and disparate impact is *Griggs v. Duke Power Company*.<sup>6</sup>

#### Case: Griggs v. Duke Power Company

Before the passage of Title VII of the Civil Rights Act of 1964, Duke Power Company openly practiced discrimination against blacks. At the Dan River Plant in Draper, North Carolina, blacks were employed only in the labor department, the lowest paying of the five operating divisions. In order to comply with Title VII, the company revised its hiring and promotion policies in 1965 so as to eliminate distinctions between blacks and whites. All applicants for jobs in any department except labor were now required to have a high school diploma and pass two standardized tests, the Wonderlic Personnel Test, which is designed to measure general intelligence, and the Bennett Mechanical Comprehension Test.

Thirteen black employees in the labor department brought suit against Duke Power Company, contending that the education and test requirements were discriminatory for two reasons.

- First, according to the 1960 census, 34 percent of white males in North Carolina had graduated from high school compared with only 12 percent for black males. The

requirement of a high school diploma, therefore, served to exclude black applicants from higher-paying jobs in other departments, in proportionately greater numbers than white applicants.

- Second, the passing scores on the two standardized tests were set by the company at the national median of high school graduates, with the result that 58 percent of whites taking the test passed, whereas only 6 percent of the blacks succeeded in doing so. Again, a requirement imposed by the company had a disproportionate impact on blacks applying for employment.

The difference between blacks and whites in the percentages graduating from high school and the performance of the two groups on the standardized tests was largely attributable to the segregated school system in the state. Thus, the requirements, although ostensibly color-blind, served to perpetuate the effects of discrimination in schooling. Chief Justice Warren Burger asserted, in the majority opinion, that “practices, procedures, and tests neutral on their face, and even neutral in terms of intent, cannot be maintained if they operate to ‘freeze’ the status quo of prior discriminatory employment practices.” Duke Power Company responded to the charge of discrimination by holding that Title VII does not require employers to treat workers without regard for qualifications. The requirement of a minimal educational attainment is reasonable, and intelligence and aptitude tests are specifically sanctioned by Section 703(h) of the Civil Rights Act. This section authorizes the use of “any professionally developed ability test” that is not “designed, intended, or used to discriminate because of race.”

The position of the Supreme Court was that neither requirement had been shown by the company to be related to successful job performance. According to the majority opinion,

On the record before us, neither the high school completion requirement nor the general intelligence test is shown to bear a demonstrable relationship to successful performance of the jobs for which it was used. . . . The evidence, however, shows that employees who have not completed high school or taken the tests have continued to perform satisfactorily and make progress in departments for which the high school and test criteria are now used. The promotion record of present employees who would not be able to meet the new criteria thus suggests the possibility that the requirements may not be needed even for the limited purpose of preserving the avowed policy of advancement within the company.

The decision in *Griggs v. Duke Power Company* interprets Title VII as prohibiting employment practices that involve no intent to discriminate (disparate treatment) but still operate to exclude members of protected classes unnecessarily (disparate impact). Companies are free to hire and promote workers on the basis of defensible

requirements. But in the words of the Court: “The touchstone is business necessity. If an employment practice which operates to exclude Negroes cannot be shown to be related to job performance, the practice is prohibited.” Moreover, the burden of proof in showing business necessity rests on the employer.<sup>7</sup>

## WRITING PROMPT

### The Intent and Impact of Employment Practices

A private security agency has a minimum height requirement of 5 feet 6 inches for all bodyguard positions. Why would someone think that this is a legitimate policy? Why would someone think that this policy is unfair or discriminatory?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 7.1.3: Forms of Discrimination

A definition cannot answer all the difficult questions about discrimination in the workplace, and some further clarification is necessary for understanding each form of discrimination. The challenge of defining discrimination has been complicated by the extension of the concept to more subtle factors, such as sexual orientation, body features, and genetic traits. Moreover, discrimination consists not only of adverse treatment based on some biasing factor but also of retaliation against individuals for protecting themselves against such treatment, for example, by filing a discrimination complaint.

Federal law prohibits discrimination on the basis of:

- race/ethnicity
- sex/gender
- religion
- national origin
- age
- disability
- genetic information

1. **Sex Discrimination.** In the interpretation of Title VII, sex discrimination is discrimination based on the fact that a person is male or female and not on sex-related matters, such as sexual orientation or marital status. Although some state and local governments have passed laws barring discrimination in employment and other matters based on sexual orientation—including discrimination against lesbian, gay, bisexual, and transgender (LGBT) individuals—discrimination of this kind is not covered by the Civil Rights Act of 1964 nor by any subsequent federal legislation. Recent decisions by the Equal Employment Opportunity Commission (EEOC) have only begun to address the complicated issue of whether

discrimination against LGBT individuals is indirectly outlawed by the Civil Rights Act’s general prohibition against “sex stereotyping.”<sup>8</sup>

Employers are permitted by Title VII to treat married and single employees differently as long as no distinction is made between men and women. An employer can give a preference in hiring to married applicants, for example, but it would be discriminatory to prefer married men and single women in filling jobs.

Because of uncertainty over the legality of discrimination against pregnant women, Congress passed the Pregnancy Discrimination Act of 1978, which amends the phrase in Title VII “because of sex” to include decisions made on the basis of “pregnancy, childbirth, or related medical conditions.” Sexual harassment has also been ruled by the courts to constitute a form of sex discrimination.

2. **Religious Discrimination.** Religious discrimination is substantially different from discrimination based on race or sex. There are instances, to be sure, of religious discrimination in which employers refuse to hire or promote individuals simply because of prejudice against members of certain religious groups, such as Catholics, Jews, and Muslims. Most charges of religious discrimination in employment, however, involve conflicts between the religious beliefs and practices of employees and workplace rules and routines. Employees sometimes request revised work schedules for Sabbath observance or time off to observe religious holidays. Members of some religious groups have special dress or grooming requirements, such as a yarmulke for Jewish men and a turban and a beard for Sikh men.<sup>9</sup> Some employees have religious objections to performing certain kinds of work or to submitting to medical examinations; others request prayer breaks and special foods in the company cafeteria.

In 1972, Congress amended Title VII by adding Section 701(j), which states that there is no religious discrimination if “an employer demonstrates that he is unable to reasonably accommodate an employee’s or prospective employee’s religious observance or practice without undue hardship on the conduct of the employer’s business.” As a result of this amendment, the bulk of the court cases involving charges of religious discrimination raise questions about what constitutes “reasonable accommodation” and “undue hardship.” In addition, the courts have held that religious objections can be dismissed by an employer when they interfere with employee safety.

3. **National Origin Discrimination.** National origin discrimination overlaps discrimination based on race, color, and, to some extent, religion. It is conceptually distinct, however, because an employer could have

employment policies that exclude Mexican immigrants but not other Hispanics, or Vietnamese but not other Asians. It is not discriminatory under Title VII for an employer to require U.S. citizenship as a condition for hiring or promotion as long as the requirement is reasonably job-related and is not a pretext for excluding members of some nationality group. Similarly, an employer is permitted by Title VII to impose a requirement that employees be fluent in English, even if it excludes recent immigrants, as long as the requirement is dictated by legitimate business reasons and is uniformly applied.

4. **Age Discrimination.** Age discrimination results largely from the benefits that employers perceive in shunting older employees aside to make room for younger employees whom they believe have more up-to-date skills and innovative ideas. Younger employees are less expensive to employ because older employees generally have higher salaries and make more extensive use of fringe benefits. Young people are sometimes preferred by employers for marketing reasons, for example, when hiring clerks in a youth-oriented clothing store. The Age Discrimination in Employment Act (ADEA), passed by Congress in 1967, follows the form of Title VII in prohibiting employers from discriminating in the hiring, promotion, discharge, compensation, or other terms and conditions of employment because of age. Exceptions to the ADEA are permitted when age is a BFOQ and in cases where a company has a bona fide seniority system. Highly paid corporate executives are also generally excluded from protection under the ADEA.
5. **Handicap Discrimination.** In many respects, discrimination against the handicapped is like religious discrimination rather than discrimination on the basis of race or sex. Employing the handicapped often requires that they be treated differently in order to compensate for their disabilities. It may be argued that employers ought to be willing to make reasonable accommodations for the impairments or disabilities of the handicapped, just as they are obligated to make reasonable accommodations for the religious beliefs of their employees.

## 7.2: Sexual Harassment

### 7.2 Define how sexual harassment and the distinct forms of sexual harassment constitute acts of discrimination

Improper sexual conduct in the workplace—which includes lewd and suggestive comments, touching and fondling, persistent attention, and requests for sexual

favors—has long been a problem for women, and increasingly for men. All too often, such sexual harassment has been regarded by employers as a personal matter beyond their control or as an unavoidable part of male–female relations. However, increased attention to the problem and developments in the law have made employers aware of their responsibilities—and employees, of their rights!

### 7.2.1: Defining Sexual Harassment

Surveys of employee attitudes reveal substantial agreement on some of the activities that constitute sexual harassment and differences on others. In particular, most of the respondents in a poll conducted by *Harvard Business Review* and *Redbook* magazine consistently rated a supervisor’s behavior as more serious than the same action by a coworker, thereby recognizing that sexual harassment is mainly an issue of power rather than a matter of sexual desire.<sup>10</sup> Barbara A. Gutek has found that over 90 percent of both men and women consider socializing or sexual activity as a job requirement to be sexual harassment. However, 84 percent of the women surveyed, but only 59 percent of the men, identified “sexual touching” as sexual harassment.<sup>11</sup> In general, women are more likely than men to label the same activity as sexual harassment.

In 1980, the EEOC issued guidelines on sexual harassment that included the following definition:

Unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature constitute sexual harassment when

1. submission to such conduct is made either explicitly or implicitly a term or condition of an individual’s employment,
2. submission to or rejection of such conduct by an individual is used as the basis for employment decisions affecting such individual, or
3. such conduct has the purpose or effect of unreasonably interfering with an individual’s work performance or creating an intimidating, hostile, or offensive working environment.

This definition makes a distinction between two kinds of harassment.

- One is *quid pro quo* harassment, in which a superior, who is usually a man, uses his power to grant or deny employment benefits to exact sexual favors from a subordinate, who is usually a woman.
- The other kind is *hostile working environment* harassment, in which the sexual nature of the conduct of coworkers and others causes a woman (or a man) to be very uncomfortable.

What constitutes discomfort is not easy to specify, but the judge in the Jacksonville Shipyards case ruled that the display of pinup calendars and pornographic pictures constitutes an

unrelenting “visual assault on the sensibilities of female workers” and that such a situation constitutes sexual harassment under the “hostile working environment” provision.

## 7.2.2: Forms of Sexual Harassment

Title VII of the 1964 Civil Rights Act and other legislation protect women against many forms of discrimination. The Equal Pay Act of 1963 forbids an employer to offer different wages to men and women who perform the same or substantially similar work unless the difference is based on some valid factor other than sex, such as seniority or productivity. Unlike race and color, sex can be a BFOQ. Many of the problems about what constitutes sexual discrimination arise in cases where a person’s sex can arguably be taken into consideration, such as in hiring guards for a male prison. In some other cases, sex is not a BFOQ, but the stated qualifications serve to exclude virtually all women. Examples are tests for police officers and firefighters that require considerable strength and endurance. Whether the qualifications are discriminatory depends largely on whether they are reasonably necessary for the performance of the job.

**QUID PRO QUO HARASSMENT** Quid pro quo harassment clearly violates the Title VII provision that men and women should not be treated differently in their “compensation, terms, conditions, or privileges of employment.” A woman who is promised a promotion or a raise—or threatened with demotion, termination, or loss of pay—based on whether she submits to the sexual demands of her boss is being held to a different standard, merely because of her sex.

Some observers contend that quid pro quo harassment, while unfortunate, is not sexual discrimination but merely a wrongful act committed by one employee against another. It is not uncommon for workers of both sexes to encounter personal problems on the job, and harassment, in this view, is one of these personal problems. However, Catharine A. MacKinnon has argued that sexual harassment in the workplace is more than “personal”; it has a connection to “the female condition as a whole” because it deprives women “of opportunities that are available to male employees without sexual conditions.” When harassment is present, the willingness to endure it becomes a condition of employment to which men are not subject.<sup>12</sup>

In *Meritor Savings Bank v. Vinson* (1986), the U.S. Supreme Court declared that “without question” both quid pro quo harassment and hostile working environment harassment (discussed next) constitute sexual discrimination under Title VII.<sup>13</sup>

**HOSTILE WORK ENVIRONMENT** The decision in the Jacksonville Shipyards case further upheld the EEOC view that a hostile working environment constitutes sexual harassment. Even when there is no demand for sexual favors, conditions in a workplace can produce a form of stress that

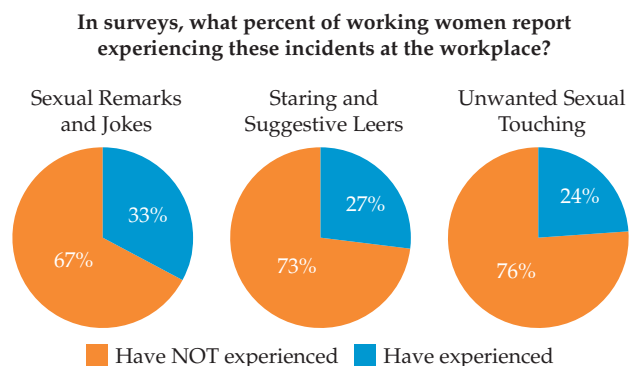
interferes with a person’s ability to work and erodes that person’s sense of well-being. Not only does a visual display of pornographic pictures produce stress, but the need to be diligent to avoid the next incident may induce more stress; and the feeling that their complaints will not produce any change further compounds the stress that harassed women have.

In reaching its decision in the Jacksonville Shipyards case, the court relied on testimony about sexual (and racial) stereotyping. Stereotyping is likely to occur when members of a group are fewer in number and when members of another group are in power. The stereotypes in sexual harassment cases are those that prevail outside the workplace where some men view women as sex objects. The conditions for stereotyping thus permit “sex role spillover,” in which women’s roles outside of employment “spill over” or become central in an environment where other roles, such as the job to be performed, ought to be the only ones relevant.<sup>14</sup> A good welder who is also a husband and father can be treated on the job only as a good welder, whereas a woman like Lois Robinson cannot escape the stereotypes that the men bring with them to the workplace. She cannot be, in their eyes, only a good welder. Stereotyping becomes more prevalent when there are “priming” elements, such as pictures that create a stimulus for harassing treatment. One effect of stereotyping is selective interpretation, whereby complaints may be perceived in accord with a stereotype, such as that women are “overly emotional.” The failure of Lois Robinson’s supervisors to take her complaints seriously may have been due to that effect.

Hostile working environment harassment is both more pervasive and more difficult to prove.

Studies have shown that quid pro quo harassment is relatively rare, but surveys suggest that the types of offensive incidents highlighted in Figure 7.1 are not uncommon.

**Figure 7.1** Factors Contributing to a Hostile Working Environment<sup>15</sup>



Not all of this conduct is considered to be sexual harassment, however, even by the women who report it. Still, a line must be drawn somewhere. One possibility is a *reasonable person* standard, whereby conduct that is offensive to a person of average sensibilities would be impermissible. However, one court has rejected this approach on the



grounds that it “tends to be male-biased and tends to systematically ignore the experiences of women.” This court has proposed, instead, a *reasonable woman* standard, which requires that the alleged harassment be judged from the recipient’s point of view.<sup>16</sup>

### 7.2.3: Further Issues

Initially, the courts were reluctant to recognize sexual harassment as discrimination unless a victim suffered some economic loss, such as a reduction in pay or the loss of a job. If this position is accepted, however, then any amount of harassment is legal as long as the victim’s employment status is not affected. In 1981, though, a court held that sexual harassment is illegal even when there is no economic loss, as long as there is psychological harm. No person, the court declared, should be forced to endure the psychological trauma of a sexually intimidating workplace as a condition of employment.<sup>17</sup> This position was expanded by the decision in *Harris v. Forklift Systems, Inc.* (1993), in which the victim could not establish even psychological harm.

Theresa Harris’s boss made disparaging comments about women, suggested that she negotiate a pay raise at a local motel, publicly announced (falsely) that she had slept with a client to get an account, and required her to retrieve change from his pants pocket. Her boss, the president of a Nashville-based truck-leasing company, claimed that he was only joking. A lower court found that the employer was “a vulgar man” but contended that his behavior was not so egregious as to seriously affect Harris’s “psychological well-being.”<sup>18</sup> In *Harris v. Forklift Systems, Inc.*, the U.S. Supreme Court ruled that no psychological harm needs to be shown as long as a reasonable person would find the conduct offensive.<sup>19</sup> In the words of one observer, “You don’t have to have a nervous breakdown, but one joke does not make a case.”<sup>20</sup> The High Court had an opportunity in the *Harris* case to affirm the *reasonable woman* standard, but the justices relied instead on the *reasonable person* standard.

The most intractable issue for the courts has been the responsibility of an employer for the conduct of an employee, especially when the employer is unaware of the harassment by an employee. In *Meritor Savings Bank, Mechelle Vinson* charged that her supervisor, Sidney Taylor, made repeated sexual advances and raped her on several occasions, but she did not report this to anyone at the bank or use the bank’s formal complaint procedure. The bank held that it was not responsible, therefore, because of the lack of knowledge. The Supreme Court disagreed, however, and held that an employer has a responsibility to ensure that the workplace is free of sexual harassment. But how far does this responsibility extend?

In two 1998 cases, *Burlington Industries v. Ellerth* and *Faragher v. City of Boca Raton*, the U.S. Supreme Court established a two-step test.<sup>21</sup>

- First, if the harassment is by a superior and results in a “tangible employment action, such as discharge, demotion, or undesirable assignment,” then the employer is liable, regardless of whether the employer knew about the harassing activity.
- Second, if there is no “tangible employment action,” the employer is still liable unless the employer can show
  1. that reasonable care was exercised to prevent and correct sexual harassment and
  2. that the employee unreasonably failed to take advantage of the opportunities provided by the employer to correct or avoid the harassing conduct.

In the decision, the Court declined to consider who is at fault in cases of harassment and focused instead on how to prevent them. Employers are now on notice that they must anticipate the possibility of harassment and take demonstrable steps to address the problem. Most companies now have detailed written policies about sexual harassment. Employees have also been told through court decisions that they have a responsibility to use whatever means an employer has made available for dealing with harassment.

#### WRITING PROMPT

##### Employer Responsibility for Harassment

Title VII of the Civil Rights Act requires employers to take preventative measures against all types of harassment in the workplace—sexual harassment as well as harassment based on protected classes, such as race, age, and religion. Why does the law hold employers—and not merely individual supervisors—responsible for harassment? Some recommend that employers be subject to law suits only if “tangible employment action” is taken against a harassment victim. What is the case against this more limited approach to harassment law?

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## 7.3: Objections to Discrimination

### 7.3 Apply and contrast arguments against discrimination that are based on utilitarianism, Kantian ethics, and principles of justice

That discrimination is wrong can be shown by a variety of arguments.

- There are, first, straightforward utilitarian arguments that cite the ways discrimination harms individuals, business firms, and society as a whole.
- A second kind of argument appeals to the Kantian notions of human dignity and respect for persons.

- Arguments of a third kind are based on various principles of justice.

Any one of these arguments is sufficient to establish the point, but it is still worthwhile to examine them all because each brings out some important aspects of the problem of discrimination.

One standard utilitarian argument favored by economists is that discrimination creates an economically inefficient matching of people to jobs. The productivity of individual businesses and the economy as a whole is best served by choosing the most qualified applicant to fill any particular position. When applicants are evaluated on the basis of characteristics, such as race and sex, that are not job-related, productivity suffers. Similarly, it is economically disadvantageous for employees to discriminate by refusing to work with blacks or women and for customers to discriminate by refusing to patronize minority-owned businesses.

### What are the difficulties with this argument?

There are a number of difficulties with this argument.

**First, not all forms of discrimination produce economic inefficiencies.** This is especially true of religious discrimination and discrimination against the handicapped where complying with the law imposes some cost. It is often cheaper for employers to dismiss employees with troublesome religious beliefs and practices and to avoid hiring handicapped people who have special needs.

**Second, it is not clear that even racial and sexual discrimination are always inefficient.** Under the assumptions of classical economic theory, employers who discriminate on the basis of race or sex are expressing a “taste for discrimination,” which they pay for by imposing a higher cost on themselves.<sup>22</sup>

**Example:** When a more productive black applicant is passed over by an employer who prefers to hire whites merely because of race, the output of that employer will be lower. The difference is a cost that the employer is presumably willing to assume in order to satisfy a preference for a white workforce. In a free market, then, employers with a taste for discrimination are liable to be driven out of business, and discrimination should be reduced over time.<sup>23</sup> This theoretical result is not always borne out in practice, and economists have offered a variety of explanations for the discrepancy.<sup>24</sup>

Another utilitarian argument focuses on the harm that discrimination does to the welfare of society as a whole by perpetuating the effects of racism and sexism. When racial discrimination in employment is combined with discrimination in education, housing, medical care, and other areas of life, the result is poverty with all its attendant social ills. Sexism also serves to disadvantage women as a group and create social problems. Employers who discriminate on the basis of race and sex thus impose an external cost on society.

An externality is also imposed when employers attempt to cut costs by refusing to hire the handicapped; the savings to employers may be more than offset by the cost to the handicapped themselves and to the society that is forced to care for them.

From a nonconsequentialist point of view, discrimination can be shown to be wrong by appealing to the Kantian notions of human dignity and respect for persons. This is especially true of discrimination based on contempt or enmity for racial minorities or women. Discrimination of this kind typically involves a racist or sexist attitude that denies individuals in these groups the status of fully developed human beings who deserve to be treated as the equals of others. The victims of racial and sexual discrimination are not merely disadvantaged by being forced to settle for less desirable jobs and lower pay. They are also deprived of a fundamental moral right to be treated with dignity and respect.

This moral right is also denied when individuals are treated on the basis of group characteristics rather than individual merit. Much of the discrimination against women, older workers, and the handicapped does not result from the belief that they are less deserving of respect and equal treatment. It results instead from the stereotypes that lead employers to overlook significant differences among individuals. Stereotypes, which are a part of racism and sexism, clearly result in a denial of dignity and respect. But stereotyping by its very nature is morally objectionable because it leads employers to treat individuals only as members of groups.

Perhaps the strongest arguments against discrimination are those that appeal to some principle of justice. Fundamental to many principles of justice is the requirement that we be able to justify our treatment of other people by giving good reasons, but to discriminate is to treat people differently when there is no good reason for doing so. According to Aristotle’s principle of justice as proportional equality—that like cases should be treated alike, and unlike cases should be treated differently in proportion to the relevant differences—discrimination is unjust because characteristics such as race and sex are generally irrelevant to the performance of a job. Even when the differences between individuals constitute genuinely job-related characteristics, the difference in pay, for example, should still be in proportion to that difference.

The contract theory of John Rawls provides the basis for yet another argument against discrimination. One of the principles that would be adopted in the original position is described by Rawls as follows: “Social and economic inequalities are to be arranged so that they are . . . attached to offices and positions open to all under conditions of fair equality of opportunity.”<sup>25</sup> Even if it were to the advantage of everyone to exclude some groups from certain positions, such a denial of opportunity could not be justified because individuals would be deprived of an important human good, namely, the opportunity for self-development.

## WRITING PROMPT

### The Case against Discrimination

Which argument against discrimination do you find most compelling? How would you convince someone that discrimination is wrong? How would you have that conversation with someone who unwittingly exhibits prejudiced beliefs or behavior?

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## 7.4: Preventing Discrimination

### 7.4 Recommend steps and measures a company can take to help ensure that its hiring and promotion processes are nondiscriminatory

Being a truly nondiscriminatory employer is not an easy task. In addition to good-faith compliance with the law, employers must be aware of some subtle and surprising sources of discrimination. This section discusses what is involved in pursuing a policy of nondiscrimination by examining three basic steps in the hiring and promotion process:

- analyzing the job to be performed,
- recruiting applicants, and
- assessing the applicants for suitability.

Assessment is commonly done by objective tests and subjective evaluations, both of which raise ethical issues in their implementation. Although training programs are undertaken for preventing many different kinds of discrimination, they are especially common for sensitizing employees about sexual harassment.

### 7.4.1: Analysis, Recruitment, and Assessment

In order to ensure that decisions on hiring and promotion consider only job-related characteristics and result in finding the best person for the job, it is necessary to conduct a *job analysis*. A job analysis consists of two parts:

1. an accurate *job description* that details the activities or responsibilities involved in a position, and
2. a *job specification* listing the qualifications required to perform the job as described.

Virtually every job in any present-day corporation has been analyzed in this way, because job analysis is a standard management tool for organizing work and appraising performance.

Because a job description focuses on the specific activities or responsibilities of a position rather than on the people who have traditionally held it, certain kinds of work are less likely to be stereotyped as belonging to one group or another. Even when the qualifications for a job favor one sex over another, a job description that lists only the qualifications will not serve to exclude the members of the other sex who meet them. Because the qualifications must be related to the description, it is easier to determine whether they are really needed for the satisfactory performance of a job. A job analysis need not be confined to traditional job categories. If a job is unnecessarily identified with one sex or another, it can be redesigned, perhaps by combining the activities of one or more other jobs, so that the newly created job is attractive to both men and women. Jobs can also be narrowed so as to avoid excluding some groups unnecessarily. A desk job that involves some moving and lifting can be redesigned to exclude these tasks in order to accommodate the handicapped.

After a job analysis is done, a company is faced with the task of recruiting applicants in a nondiscriminatory manner. An obvious first step is to make sure that information about an opening is widely disseminated, especially to nontraditional groups. Employers who are serious about not discriminating will place listings of job opportunities with minority publications and educational institutions and employment agencies serving minorities. Also, applications from members of nontraditional groups are more likely to be received if significant numbers of minorities and women are involved in the company's recruitment effort and if a number of nontraditional applicants are hired at one time.<sup>26</sup>

Once a sufficient number of applicants have been recruited, the next task is to select the person who is best suited to fill the job. Discrimination can enter into this stage of hiring in many different ways. The selection process itself, which often includes a battery of tests and rounds of interviews, can be discouraging for many nontraditional applicants. Employers can address this problem by simplifying the application procedure or providing instruction on how to proceed. Small differences in treatment can also make racial minorities and women feel uncomfortable. A company can further reduce the barriers to non-traditional applicants by increasing the range of jobs open for promotions, so that minorities and women have more opportunities for advancement.

### 7.4.2: Objective Tests

Objective tests consist of true/false, multiple choice, or similarly constructed questions, which require only a soft-lead pencil and quick, accurate responses.

Three kinds of objective tests are commonly used to make decisions on hiring and promotion:

1. tests that measure specific knowledge and skills, such as those needed to be a bookkeeper or a typist;
2. tests that measure intelligence and general aptitude for performing certain kinds of work; and
3. tests that attempt to gauge an applicant's suitability for employment generally and the extent to which an applicant will fit into a specific work environment.

Objective tests of these kinds are permissible under Title VII of the 1964 Civil Rights Act as long as they are not used as a cover for discrimination. One condition laid down in *Griggs v. Duke Power Company*, however, is that a test cannot unnecessarily exclude a disproportionate number of protected class members, which is to say it should not have disparate impact. A second condition is that a test be validated; that is, an employer must be able to show that a test for any given job is a reliable predictor of successful performance in that job. The two tests administered by Duke Power Company, the Wonderlic Personnel Test and the Bennett Mechanical Comprehension Test, are professionally prepared instruments that presumably provide an accurate measure of general intelligence and mechanical ability, respectively. What the company failed to prove, however, is that passing scores on these tests are closely correlated with successful job performance. They failed, in other words, to validate the tests that they used.

The Supreme Court has held employers to very high standards of proof in validating tests. It is not sufficient merely to show that employees who successfully perform a certain job also attain high scores on any given test. An employer must be able to show, further, that applicants with lower scores would not be capable of performing just as well. A biased test that results in the exclusion of a substantial percentage of blacks or women, for example, might still be a reliable predictor of successful performance for those who pass but not a reliable predictor of the lack of success of those who fail the test. Furthermore, comparing the scores of employees who are currently performing a job successfully with the scores of inexperienced applicants is not sufficient proof of the reliability of a test. In order to draw a significant conclusion, it would be necessary to know how the current jobholders would have scored on the test before they were hired.<sup>27</sup>

### 7.4.3: Subjective Evaluations

Objective tests are ethically and legally permissible, then, as long as they do not have disparate impact and are validated. Do the same two conditions apply to subjective evaluations based on personal interviews or the recommendations of supervisors? On the one hand, evaluations of this kind are made by experienced employees who are well acquainted with the job to be filled and have an opportunity to assess

qualities in an applicant that do not lend themselves to objective testing. On the other hand, the evaluations of interviewers and supervisors are apt to be influenced by irrelevant factors, such as a person's appearance or manner, and by conscious or unconscious prejudice. This is especially true when the evaluator is not well trained for the task.

The first opportunity for the Supreme Court to decide on the conditions for an acceptable subjective evaluation system came in 1988 with the suit of Clara Watson against the Fort Worth Bank and Trust Company.

#### Case: Clara Watson v. Fort Worth Bank and Trust

In 1976, Clara Watson was one of the few blacks ever employed as a teller by the Fort Worth Bank and Trust. Her ambition, though, was to become a supervisor in charge of other tellers at the bank despite the fact that only one other black person had ever held this position.<sup>28</sup> She applied to be a supervisor on four separate occasions, and each time she was denied the position. The bank claimed that all promotion decisions were based strictly on evaluations of fitness for the job and that race was not a factor in filling any of the vacancies for which Clara Watson applied. However, a study showed that during a four-year period, white supervisors at the bank hired 14.8 percent of the white applicants and only 3.5 percent of the black applicants. The same supervisors rated black employees 10 points lower than white employees on a scale used for annual salary evaluations. As a result, blacks were promoted more slowly from one salary grade to another and earned less. In 1981, Clara Watson left the bank, but not before she went to the EEOC and filed a charge of racial discrimination.

The Fort Worth Bank and Trust Company used three common types of subjective evaluation procedures: interviews, rating scales, and experience requirements. Rating scales differ from interviews in that they record evaluations derived from observations made over a long period of time while an employee is actively at work. Typically, an evaluator is asked to rank an employee on a numerical scale with respect to certain qualities, such as drive and dependability. Experience requirements involve an inventory of specific jobs performed that provide a basis on which to make judgments about future performance.

The American Psychological Association (APA) submitted an *amicus curiae*, or "friend of the court," brief in the Watson case in order to support the claim that these three types of subjective evaluation procedures are capable of validation.<sup>29</sup> Each procedure is open to bias. The most common bias in interviews and rating scales is the "halo effect," in which a single trait exercises an inordinate influence on an evaluator. Closely related to the halo effect is stereotyping, in which assumptions about members of certain groups influence an evaluator. Interviewers are also subject to the "similar-to-me" phenomenon, in which they are inclined to be more favorable to people who have the same traits as themselves. Among the problems with rating scales are the tendencies of evaluators to place persons

toward the center of a scale, thereby avoiding the extremes, and to be lenient, scoring most people favorably. The APA brief also cites considerable evidence to show that scores on rating scales are affected by racial factors.

All of these biases can be avoided by subjective evaluation procedures that are designed and carried out according to the APA's *Standards for Educational and Psychological Testing and the Principles for the Validation and Use of Personnel Selection Procedures*. The key in each type of procedure is to relate it to a thorough analysis of the job to be filled. The interview should be carefully structured with questions designed to elicit information that is relevant only to the qualifications and performance criteria of the job. The traits on the rating scale and the kinds of experience used as experience requirements should be similarly selected. As much as possible, the results of evaluation procedures should reflect the personal characteristics of the person being evaluated and not the person doing the evaluating, so that differences between evaluators are kept to a minimum. Interviewers, supervisors, and other persons involved in the process should be thoroughly trained in performing their roles in the hiring and promotion process.

The APA brief faults Fort Worth Bank and Trust for failing to meet the generally accepted standards for subjective evaluation procedures and for the lack of any validation of the procedures used. Interviews were conducted by only one person, a white male, and there is no evidence that the questions were carefully designed with job-related qualifications in mind. No job analysis was done in order to guide the selection of questions in the interview and the traits on the rating scale. Moreover, the traits on the rating scale were vaguely defined and not clearly related to job performance. The supervisors who performed the ratings were not specifically trained for that task, and no steps were taken to avoid the effect that race is known to have on the results of rating scales. Finally, it would be impossible without a job analysis of the position to determine what prior experience would enable her superiors to judge the success of Clara Watson in that position.

In an 8–0 decision, the Supreme Court found in favor of Clara Watson and established that the theory of disparate impact applied to subjective evaluation procedures as well as to objective tests of the kind at issue in *Griggs*.

## WRITING PROMPT

### Bias in Subjective Evaluations

Why do some claim that face-to-face interviews and scaled ratings of past performance are both susceptible to bias? How can a company or hiring manager try to prevent bias in one, or both, of these methods of evaluation?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 7.4.4: Sexual Harassment Programs

Although sexual harassment is usually committed by one employee against another, employers bear both a legal and an ethical obligation to prevent harassment and to act decisively when it occurs. Harassment is more likely to occur when management has not prescribed clear policies and procedures with regard to conduct of a sexual nature. Employers who display an insufficient concern or have inadequate procedures for detecting harassment in the workplace bear some responsibility for individuals' harassing conduct. In addition, companies cannot fully evade responsibility by blaming the victim for not reporting sexual harassment in accord with established procedures. The way in which employers respond to claims of sexual harassment sends a powerful message about the seriousness with which management takes its own policies and procedures. The legal duty of an employer also extends to harassment by nonemployees, such as customers and clients.

Aside from the costs of legal compliance—including the cost of litigating and paying settlements—employers have other strong financial incentives to avoid sexual harassment. In 2014, the EEOC settled 786 charges of sexual harassment and obtained \$35 million in settlements.<sup>30</sup> However, this figure does not include additional amounts received by victims through private litigation. It also does not include losses from absenteeism, low morale, and employee turnover, which are hidden costs that sexual harassment inflicts on companies. According to one study, productivity suffers when women are forced to waste time avoiding uncomfortable situations or to endure the stress of coping with them.<sup>31</sup> The stress induced by sexual harassment also leads to health problems, loss of self-confidence, and a lack of commitment, all of which may reduce career prospects and deprive employers of valuable talent. Women who have been harassed are more likely to seek transfers or to quit, thereby increasing the cost of employee training.

Most corporations have recognized the cost of sexual harassment and accepted their responsibility to prevent it by establishing programs to deal with it on the job. The major features and steps for developing these programs are shown in Figure 7.2.

### 1. A Sexual Harassment Policy

The first step in a corporate program to eliminate sexual harassment is a firm statement from a high level in the organization that certain conduct will not be tolerated. The policy statement should not only convey the serious intent of management but also describe the kinds of actions that constitute sexual harassment. A good policy should educate as well as warn.

### 2. Communicating the Policy

No policy can be effective unless it is effectively communicated to the members of the organization, and effective

**Figure 7.2** Developing a Sexual Harassment Prevention Program



communication is not merely a matter of making the policy known but of gaining understanding and acceptance of the policy. Many corporations include sexual harassment awareness in their initial training and ongoing education programs to secure compliance, often utilizing videos of situations and simulation games to heighten employee sensitivity to the issues.

**3. Setting up Procedures**

A complete policy should include a well-publicized procedure for handling incidents of sexual harassment with assurances of nonretaliation against an accuser. Employees should be informed of the procedure to follow in making a complaint, including the specific person or office to which complaints should be made and preferably offering several alternatives for making complaints. In addition, those who handle complaints should be aware of the procedure they should follow. The policy should assure all parties—the accuser as well as the accused—of confidentiality. The investigation itself should seek to ascertain all the relevant facts and to observe the rules of due process, especially in view of the harm that could result from false accusations.

Although companies should have a formal complaint procedure, some also make use of an informal process through which a situation may be resolved to the victim’s satisfaction. An informal procedure is well suited for less-serious, infrequent incidents among peers where there is some misunderstanding or insensitivity; it is inappropriate for repeat offenses with multiple victims and for harassment by a victim’s superior.

**4. Taking Appropriate Action**

Any disciplinary action—which may include a reprimand, job transfer, demotion, pay reduction, loss of a bonus, or termination—should aim, at a minimum, to deter the offender and perhaps to deter others in the organization (although the deterrent effect on others will depend on publicizing the penalty). Because the victims of harassment may have suffered some job loss or been deprived of some opportunities, a proper resolution may also include compensating the victims for any harm done.

Use Table 7.1 to quiz yourself on these components of an effective anti-harassment program.

**Table 7.1** Goals of Sexual Harassment Programs

Program Components	Goals
<b>1. A Sexual Harassment Policy</b>	To warn that certain conduct will not be tolerated and convey the seriousness of management.
<b>2. Communication and Training</b>	To make the company policy known, understood, and accepted, and increase awareness of harassment.
<b>3. Reporting Procedures</b>	To provide a formal, confidential process for making and responding to a complaint internally, without fear of retaliation.
<b>4. Disciplinary Action</b>	To deter the offender and perhaps others in the organization, and compensate the victim if appropriate.

## 7.5: Affirmative Action

**7.5 Analyze the various issues, arguments, and problems associated with affirmative action plans and court decisions**

After the passage of the 1964 Civil Rights Act, employers scrutinized their hiring and promotion practices and attempted to eliminate sources of discrimination. However, even the best efforts of companies did not always succeed in increasing the advancement opportunities for women and racial minorities. As a result, many companies and other organizations established affirmative action plans in order to address the problem of discrimination more effectively. In some instances, these plans were adopted in order to be in compliance with Title VII; in others, the intent was to go beyond what the law requires.

Although the goal of eliminating discrimination in employment has generally been accepted in business, people are still divided over the appropriate means. Advocates of affirmative action argue that special programs are required as a matter of “simple justice.” Victims of discrimination, they say, deserve some advantage. Preferential

treatment is necessary to ensure equality of opportunity. Opponents counter that if it is unjust to discriminate against racial minorities and women on account of their race or sex, then it is similarly unjust to give them preference for the same reason. People who are passed over in favor of a black or a woman are victims of discrimination in reverse. Who is right in this debate?

### 7.5.1: Affirmative Action Plans

In 1974, at a plant operated by the Kaiser Aluminum Company in Grammercy, Louisiana, only five skilled craft workers (out of 273) were black. Kaiser had long sought out qualified black workers, but few met the requirement of five years of prior craft experience, in part because of the traditional exclusion of blacks from craft unions. In an effort to meet this problem, Kaiser Aluminum and the local union, the United Steelworkers of America, developed an innovative program to train the company's own employees to become skilled craft workers. The plan set up a training program that admitted blacks and whites in equal numbers based on seniority until the proportion of blacks in the skilled craft category equaled the percentage of blacks in the area workforce, which was approximately 39 percent.

In 1978, Santa Clara County in California undertook a similar effort. According to the 1970 census, women constituted 36.4 percent of local workers. Only 22.4 percent of county employees were women, and these were concentrated in two areas: paraprofessionals (90% female) and office and clerical workers (75.9% female). Out of 238 skilled craft workers, not one was a woman. In order to correct these imbalances, the county board adopted an Equal Employment Opportunity Policy that set broad goals and objectives for hiring and promotion in each agency. Specifically, the policy stated,

It is the goal of the County and Transit District to attain a work force which includes in all occupational fields and at all employment levels, minorities, women and handicapped persons in numbers consistent with the ratio of these groups in the area work force.

To carry out the board's policy, the Santa Clara Transportation Agency, the agency responsible for road maintenance in the county, developed a detailed plan for increasing the percentages of women and minorities in job categories where they were underrepresented.

The programs adopted by Kaiser Aluminum and Santa Clara County are examples of *affirmative action*. The idea behind affirmative action is that merely ceasing to discriminate is not enough. Employers, if they choose to do so, ought to be permitted to take more active steps to ensure a balanced workforce, including plans that give preference to job applicants on the basis of race or sex. In response to the plan at Kaiser Aluminum, however, a white employee, Brian Weber, sued both the company and his own union.<sup>32</sup>

Weber had insufficient seniority to be admitted as a white trainee, even though he had worked longer at the Kaiser plant than any of the blacks who were selected. He charged, therefore, that he himself was a victim of discrimination in violation of Title VII of the 1964 Civil Rights Act.

A suit also arose as a result of the plan adopted by the Transportation Agency of Santa Clara County when a white male, Paul Johnson, was passed over for promotion and the job went to a woman.<sup>33</sup> In December 1979, Paul Johnson and Diane Joyce applied along with 10 other employees for promotion to the position of dispatcher for the road division of the transportation agency. Dispatchers, who assign road crews, equipment, and materials for road maintenance and keep records of the work done, are classified as skilled craft workers. Applicants for the position were required to have four years of dispatch or road maintenance experience with Santa Clara County. The eligible candidates were interviewed by two different boards. The first board, using a numerical scale, rated Johnson slightly above Joyce (75 to 73), and the second board, although rating both candidates "highly qualified," also recommended Johnson over Joyce. The director of the agency was authorized to select any eligible candidate, however; and in order to implement the affirmative action plan, he gave the nod to Joyce. Johnson, like Weber, believed himself to be a victim of discrimination and sued.

Another kind of affirmative action plan that has been challenged in the courts is a "set-aside" provision for minority contractors. The Public Works in Employment Act, passed by Congress in 1977, required that at least 10 percent of the funds granted to state and local governments for construction be set aside for "minority business enterprise." Some municipalities have enacted similar legislation. The city of Richmond, Virginia, for example, adopted a Minority Business Utilization Plan that required recipients of city construction contracts to subcontract at least 30 percent of the dollar amount of each contract to minority-owned businesses. Some white contractors have charged that set-aside provisions are an illegal form of discrimination.<sup>34</sup>

### 7.5.2: Court Actions on Plans

In *Weber v. Kaiser Aluminum* and *Johnson v. Transportation Agency*, the Supreme Court held that the affirmative action plans in question were not discriminatory under Title VII. In its decisions, the Court used a standard of "strict scrutiny," which means that any affirmative action plan must serve a "compelling state interest" and must be "narrowly tailored" to achieve that interest. These plans met this standard, and both Brian Weber and Paul Johnson thus lost their suits. However, after approving set-asides for minority-owned contractors in a 1980 decision, *Fullilove v. Klutznick*, the Court cast all such programs into doubt in

*City of Richmond v. J. A. Croson* (1989) and subsequently *Adarand v. Peña* (1995).

In 2003, the Supreme Court revisited affirmative action and, for the most part, reaffirmed the status quo. In two cases, both involving the University of Michigan, the justices upheld an affirmative action program in the law school while striking down a similar plan in an undergraduate college.<sup>35</sup> The main difference between the two plans was that the law school admissions process considered race as one of many factors in achieving a diverse student body, whereas the undergraduate college assigned a point value for race as part of a numerical scale. The principle emerging from these two decisions seems to be that diversity is a valid objective for universities but that it matters how diversity is achieved. The end is not in question, but the means are. This basic finding was reaffirmed in 2014 when the Supreme Court returned an admissions case involving the University of Texas back to a lower court, which subsequently found that the university's policy legitimately used race as part of its holistic admissions process.<sup>36</sup>

**What aspects of the University of Michigan Law School's admissions policy helped to convince the Court that it was serious about diversity?**

The University of Michigan Law School official admissions policy requires that each applicant be evaluated on the basis of all information that is available in the files with a view to obtaining a diverse student body "with varying backgrounds and experiences who will respect and learn from each other." This policy does not identify all the factors that might contribute to diversity, nor does it assign a specific weight to any one factor. However, the policy does reaffirm the law school's long-standing commitment to "racial and ethnic diversity" for groups that have been "historically discriminated against." This kind of diversity is only one component, though, of a broader conception of diversity that is sought for the school's student body.

The law school's admission procedure thus satisfies the court's requirement of "strict scrutiny." The decision recognizes that diversity, broadly conceived, is a legitimate goal for an educational institution and that the law school's flexible, "holistic" admissions process is well designed to achieve that goal. The school maintains that if a purely "race-blind" procedure had been used in 2000, minority students would have comprised only 4 percent of the entering class instead of the actual 14.5 percent. The undergraduate college admissions process, by contrast, while designed to achieve the same kind of diversity, merely added 20 points for minority status to the 100 points required for admission (out of a possible 150 points). This rather mechanical procedure, the court held, was not tailored narrowly enough; same end, wrong means.

The court's approval of the Michigan Law School admissions plan was greeted with great relief by business.

Many corporations, including 3M, General Motors, and Microsoft, had filed "friend of the court" briefs in support of affirmative action because of their leaders' belief that diversity is also important for business, especially in an era of globalization. The majority opinion noted, "These benefits are not theoretical but real, as major American businesses have made clear that the skills needed in today's increasingly global marketplace can only be developed through exposure to widely diverse people, cultures, ideas, and viewpoints." As one executive observed, diversity is "something that business has been highly committed to for at least the last decade and has made tremendous strides in improving. The belief in diversity is not something that is argued anymore in business. It's a factor of being in business."<sup>37</sup>

### 7.5.3: Compensation Argument

One argument for giving preferential treatment to members of certain groups is that it is owed to them as *compensation* for the injustice done by discrimination directed against them personally or against other members of a group to which they belong. The root idea in this argument derives from Aristotle's discussion in Book V of the *Nicomachean Ethics*, in which he distinguished between justice in the distribution of goods (distributive justice) and justice where one person has wrongfully inflicted some harm on another (corrective justice). In the latter case, justice requires that the wrong be corrected by providing compensation.

**Example:** If A, while driving carelessly, crashes into B's new car, then B suffers a loss that is A's fault. An injustice has been done. It can be corrected, though, if A compensates B for the amount of the loss, say the cost of repairs plus any inconvenience. Similarly, if A has a right not to be discriminated against and B discriminates, thereby harming A unjustifiably, then it is only just that B compensate A to correct the harm done.

Aristotle's analysis perfectly fits the situation, for example, of an employer who has been found guilty of discriminating against women or racial minorities by assigning them to lower-paying jobs and bypassing them in promotions. The law in such cases is guided by the dictum "No right without a remedy," which is to say that a person cannot be said to have a right unless there is also some means of correcting a violation of that right. If we have a right not to be discriminated against, then the courts should be able to provide some remedy when that right is violated. The remedy is often to require the employer to pay the victims the difference between what they actually earned and what they would have earned had no discrimination taken place and to advance them to the positions that they would have attained.

**WHO DESERVES COMPENSATION?** Critics of affirmative action charge that not all affirmative action plans are



justified by the compensation argument because the individuals who are given preferential treatment are often not the same as those who are victims of discrimination. Affirmative action plans almost always single out persons as members of a group that has suffered discrimination without requiring any evidence that the persons themselves have been victimized in any way. A person may be a member of a disadvantaged group and yet lead a rather privileged life, relatively free of the effects of discrimination.

Defenders of affirmative action respond that racial, ethnic, and sexual discrimination have subtle psychological effects despite the profound changes that have taken place in our society, and racial and sexual discrimination affect all members of that group to some degree. Bernard R. Boxill observes that the critics' objection involves a non sequitur. From the premise that better-qualified blacks or women are less deserving of compensation than some who have been more severely handicapped by discrimination, we cannot conclude that no compensation is owed. "Because I have lost only one leg," he argues, "I may be less deserving of compensation than another who has lost two legs, but it does not follow that I deserve no compensation at all."<sup>38</sup> Nor does it follow, according to Boxill, that victims of discrimination who succeed in overcoming the harm done to them are any less deserving of compensation than those who are unable to succeed to the same degree.<sup>39</sup>

This response still does not answer the following question.

Why should preference not be given to those who most deserve compensation, the people who have most suffered the effects of racial discrimination and who are consequently among the least qualified?

One reply is that giving preference in hiring is only one way of compensating individuals for past discrimination, and it is a way that is of greater help to those who are better qualified for the jobs available. Those who have been more disadvantaged by discrimination may be less able to benefit from affirmative action and may derive greater benefit from other forms of help, such as job-training programs.

A defender of affirmative action can also argue that claims of compensatory justice must be balanced against another principle of justice, the principle that hiring should be done on the basis of competence.<sup>40</sup> Giving preference to the best qualified of those who are deserving of compensation, according to this argument, is the best way of accommodating these two conflicting principles. Another argument cites the practical difficulty of evaluating each case to determine the extent to which an individual has been harmed by discrimination and hence deserves compensation. Giving preference to members of groups without regard for the particulars of individual cases, therefore, is a matter of administrative convenience.<sup>41</sup>

**PUNISHING THE INNOCENT** A second objection to the compensation argument is that in affirmative action the burden of providing compensation often falls on individuals who are not themselves guilty of acts of discrimination. In the competition for admission into colleges and universities and for hiring and promotion in jobs, it is largely white males who are asked to pay the price of correcting injustices that are not of their making.

Critics ask, Why should a few white males bear such a disproportionate burden?

1. *To Compensate for Past Privilege.* One answer to this question is that white males, even when they are not themselves guilty of discrimination, are still the beneficiaries of discrimination that has occurred and thus are merely being asked to give back some ill-gotten gain. This response does not fully meet the critics' point, however. Even if all white males have benefited to some degree, it still needs to be shown that what is given up by the few white males who are passed over when preference is given to others is equal to the benefit they have obtained by living in a discriminatory society that favors them. Furthermore, it would still seem to be unjust to place the full burden in such an arbitrary manner on a few when so many other members of society have also benefited from discrimination.<sup>42</sup>
2. *To Forgo Future Privilege.* A second answer to the critics' question is that white males are typically asked not to give up gains they have already made but to forgo a future benefit to which no one has an undisputed right.<sup>43</sup> Brian Weber and Paul Johnson, for example, were not deprived of any gains they had made but only of an opportunity for advancement. Although this is a real loss, neither one had a right to be selected but only a right not to be discriminated against in the selection process. If the compensation argument is correct, then those who were selected *deserved* the advantage given by their race or sex and hence no discrimination took place. (Ironically, the opportunity for Brian Weber to receive on-the-job training for a skilled craft position would not have existed had Kaiser Aluminum not adopted an affirmative action plan in order to hire more blacks.) Still, if the job prospects of white males are substantially reduced by affirmative action, then they have suffered a loss. There is surely some limit on the amount of compensation any individual or group of individuals can justifiably be required to pay.

Accordingly, the courts have laid down three conditions for permissible affirmative action plans to protect those adversely affected by them. They are

1. that a plan does not create an absolute bar to the advancement of any group,

2. that the plan does not unnecessarily trammel the rights of others, and
3. that it be temporary.

The training program in the Weber case was open to black and white workers in equal numbers. Although Brian Weber failed to gain admittance to the first class, his seniority would have assured him a place eventually. In addition, he had other opportunities for realizing his ambition of becoming a skilled craft worker. Finally, the training program was scheduled to terminate when the proportion of black craft workers reached 39 percent, the percentage of blacks in the local workforce.

### WRITING PROMPT

#### Action at Expense to Others

Suppose you met someone who asserted that affirmative action is unfair because it can only be carried out for some groups at the expense of those who have benefited from the status quo. What would your response to this person be? Explain why the benefits of affirmative action programs may outweigh this alleged unfairness.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 7.5.4: Equality Arguments

According to Aristotle, justice is a kind of equality. Whether affirmative action is just, therefore, can be decided, perhaps, by the principle that people ought to be treated equally or treated as equals. Two quite different concepts of equality are relevant to the debate over affirmative action, however. These are *equality of opportunity* and *equality of treatment*.

Justice, in the first interpretation of equality, requires that everyone have an equal opportunity to succeed in life and that no one be held back by arbitrarily imposed restraints or barriers. Better enforcement of the laws against discrimination can help to equalize the opportunities for everyone, but the effects of past discrimination also need to be neutralized in some way.

President Lyndon B. Johnson expressed the argument graphically in a 1965 commencement address at Howard University on an executive order requiring every federal contractor to be an “equal opportunity employer”:

Imagine a hundred yard dash in which one of the two runners has his legs shackled together. He has progressed 10 yards, while the unshackled runner has gone 50 yards. How do they rectify the situation? Do they merely remove the shackles and allow the race to proceed? Then they could say that “equal opportunity” now prevailed. But one of the runners would still be forty yards ahead of the

other. Would it not be the better part of justice to allow the previously shackled runner to make up the forty yard gap; or to start the race all over again? That would be affirmative action towards equality.

The equal opportunity argument addresses not only the harm done to individuals from past discrimination but also the barriers posed by discrimination in present-day society. Many fully qualified individuals from underrepresented groups have not been disadvantaged by past discrimination but are still at a competitive disadvantage because of lingering bias on the part of employers. Giving preferential treatment may be necessary under such circumstances simply to ensure that people are considered equally. Whether this is true depends, in part, on what we mean by equal opportunity.

**MEANING OF EQUAL OPPORTUNITY** What does equal opportunity mean? To say that every child born today has an equal opportunity to become a surgeon, for example, has two distinct senses. One interpretation is that each child initially has an equal chance in the same way that every ticket holder is equally likely to win the lottery. The other is that the means for pursuing the career of a surgeon are open to all. Following Douglas Rae in his book *Inequalities*, let us call these two possibilities the *prospect-regarding* and the *means-regarding* interpretations of the concept of equal opportunity.<sup>44</sup> Prospect-regarding equality aims at eliminating *all* factors affecting the distribution of goods in a society except for mere chance. Means-regarding equality, by contrast, is compatible with considerable inequality of prospects. The only requirement for equality of opportunity in this latter interpretation is that the results reflect only differences in personal attributes and not differences in the means available to persons.

Equality of prospects is an ideal of egalitarians who want to minimize the effect of “accidents” of birth on people’s success in life. Just as our race or sex should have no bearing on what we are able to achieve, so too should it not matter whether we are born into wealth or poverty or whether we are born with certain mental or physical endowments. There are a number of difficulties with interpreting equal opportunity as equality of prospects.

#### Problems with Prospect-Regarding Equality:

- First, because people begin life with vastly different prospects, steps would have to be taken to equalize these prospects. Achieving an equality of prospects would entail considerable remedial education and a reallocation of resources to schools with disadvantaged students.
- Second, how are we to know when unequal prospects have been offset? One way might be to look at equality of outcomes, but equality of prospects need not result in equal outcomes if people make different choices. So there must be some way of determining when prospects are equal without looking at the outcomes.

The interpretation of equal opportunity as equality of means entails that rewards should be distributed on the basis of some relevant criteria. Artificial barriers to advancement, such as racial or sexual characteristics, are irrelevant and should be removed, but justice does not require the removal of inequalities in prospects resulting from differences in a person's various physical and mental characteristics. Equal opportunity, on this view, means a chance to compete under fair conditions.

#### Problems with Means-Regarding Equality:

- One difficulty with this interpretation is that it requires only that all discrimination cease; it does nothing to address President Johnson's concern about the head start provided by discrimination in the past.
- A further difficulty is that the conditions for fair competition are highly suspect. What is commonly called "talent" is largely the acquisition of the expertise and skills provided by education and certified through formal procedures. If access to education or certification is affected by racial or sexual discrimination, then we can scarcely be said to have equal access to the means for achieving success in life.

**OPPORTUNITY OR TREATMENT?** Some defenders of affirmative action have argued that the goal ought not to be equal opportunity but equal treatment. This concept, too, is ambiguous, with two distinct senses. Ronald Dworkin points out that when we say that certain white males have been denied a right to equal treatment, we might have in mind two different rights.<sup>45</sup>

The first is the right to *equal treatment*, which is the right to an equal distribution of some opportunity or resource or burden. . . . The second is the right to *treatment as an equal*, which is the right, not to receive the same distribution of some burden or benefit, but to be treated with the same respect and concern as anyone else.<sup>46</sup>

The right to equal treatment in the sense of a right to receive an equal share applies only to a few things, such as the right that each person's vote shall count equally. In the distribution of most things, it is a right to the same respect and concern that is at stake. Affirmative action is objectionable, then, only if the alleged victims are not treated as equals.

Dworkin argues that any selection process advantages some people and disadvantages others. Admitting students to medical school on the basis of academic preparation, for example, serves to exclude some applicants. Such a selection process is justified, however, by a social good that outweighs any harm done to those who are turned away. Affirmative action plans are adopted to serve an important social good, namely, overcoming the effects of racism. In so doing, it must be recognized that some white applicants who are denied admission to medical school

would be admitted in the absence of a plan. In adopting rules for medical school admission that best meet the needs of society, no one has cause to complain so long as:

- the interests of these unsuccessful applicants are taken into consideration with the same respect and concern as those of others, and
- the rules for admission are applied impartially, showing the same respect and concern to every applicant.

With these conditions met, everyone has been treated as an equal.

This argument is open to serious objections.<sup>47</sup> In Dworkin's interpretation, the right to equal treatment is the right to equal respect and concern as rational calculations are made about the social good. According to Robert L. Simon, "So understood, the right to treatment as an equal looks suspiciously like the utilitarian requirement that everyone count for one and only one in computing social benefits and burdens."<sup>48</sup> Simon suggests that placing more emphasis on *respect* for other persons rather than on concern that their *welfare* be given equal weight would make affirmative action programs less compatible with equal treatment interpreted as treatment as an equal.

The conclusion to be drawn from the discussion in this section is that the concept of equal opportunity is too vague and ambiguous to provide conclusive support for any particular position on the justification of affirmative action. Those who favor preferential treatment programs and those who oppose them can find a meaning of "equal opportunity" to fit their particular position. Equality of treatment, by contrast, provides a more solid basis for affirmative action. This principle demands, however, that we think carefully about the reasons for affirmative action and make sure that the goals to be achieved are worthwhile and cannot be attained by means that do not involve taking race or sex into account.

### 7.5.5: Utilitarian Arguments

Unlike the two previous arguments for affirmative action, arguments based on utility do not hold that programs of preferential treatment are morally *required* as a matter of justice but that we are morally *permitted* to use them as means for attacking pressing social problems. Utilitarian arguments stress that preferential treatment programs are necessary to eradicate lingering racial and sexual discrimination and to accelerate the pace of integrating certain groups into the mainstream of American society. The underlying assumption of these arguments is that racism and sexism are deeply embedded in the major social, political, and economic institutions of our society and in people's attitudes, expectations, and perceptions about social realities. If this assumption is correct, then antidiscrimination legislation addresses only the surface manifestations

of racism and sexism and does not penetrate to the root causes. Action must be taken to change the institutions of society and the ways people think about themselves and their world. Otherwise, the goal of a discrimination-free society will come only slowly, if at all.

Preferential treatment programs serve to combat the effects of discrimination in a number of ways.

- First, they make more jobs available to racial minorities, women, and others through lowering the stated qualifications and formal accreditation required for hiring and promotion.
- Opportunities for groups subject to discrimination are further increased by breaking down stereotypes in the eyes of employers and the rest of society, and by creating role models for people who would not otherwise consider certain lines of work. The long history of sexual and racial stereotyping of jobs in this country has hampered the acceptance of women and members of some racial minorities into desirable positions in our society, and this history has also affected the very people who were excluded by limiting their career aspirations.
- Finally, affirmative action increases opportunities by heightening awareness about discrimination and changing the hiring and promotion process. When business firms make a commitment to achieve a certain racial and sexual mix in their workforce with established goals, the officials responsible for hiring and promoting employees cannot help but be sensitive to the issue of discrimination in every decision they make.

Affirmative action also provides a direct economic benefit to corporations themselves by increasing the pool of job applicants and generally improving community relations. Discrimination introduces inefficiency into the job market by excluding whole groups of people on the basis of race or sex, some of whom are highly qualified. The result is that people in these groups tend to be “underutilized” in jobs that do not make full use of their abilities and training, and employers are deprived of the best possible workforce. The following statement by an executive of Monsanto Corporation testifies to the benefit that affirmative action can have for employers: “We have been utilizing affirmative action plans for over 20 years. We were brought into it kicking and screaming. But over the past 20 years we’ve learned that there’s a reservoir of talent out there, of minorities and women that we hadn’t been using before. We found that it works.”<sup>49</sup>

### 7.5.6: Problems with Affirmative Action

Affirmative action has some significant undesirable consequences that must be balanced against the undeniable utilitarian benefits of preferential treatment programs. Three

arguments in particular are commonly used by opponents of affirmative action. These are that

1. affirmative action involves hiring and promoting less qualified people and lowering the quality of the workforce,
2. it is damaging to the self-esteem of employees who are favored because of race or sex, and
3. it produces race consciousness, which promotes rather than fights discrimination.

Let us examine these in turn.

**QUALITY OBJECTION** The first argument—the quality objection—can be expressed in the following way. The most qualified person for a position has no need for special consideration. Therefore, a person who is given preference on the basis of race or sex cannot be the most qualified person and cannot perform as well in a job as someone who is more qualified. The result is a decline in the quality of goods and services, which has an adverse effect on the whole of society.

A supporter of affirmative action can question, first, how much quality is given up. Preferential treatment does not involve the hiring or promotion of people who are *unqualified* but who are (at worst) *less* qualified to some degree. And the degree can be so slight as to be of no significance. Many jobs require only minimal qualifications and can readily be mastered by persons of normal abilities. Even occupations requiring considerable ability and expertise involve many tasks that can satisfactorily be performed by people who are not the best available. In many instances, “qualified” means “already trained,” which brands as unqualified those people who are capable of being fully competent with some training.

Also, whether a person is qualified for a certain job depends on how qualifications are recognized or determined. Conventional measures, such as standardized tests and academic records, are often criticized for containing a bias against women and racial minorities. The credentials used to certify competence in various fields, such as licenses, certificates, union cards, diplomas, and the like, have been accused of containing a similar bias. More complications emerge when we ask, what are the relevant qualifications for the performance of any given job? It is sometimes argued, for example, that a black police officer can be more effective in a black community and that an applicant’s race is, therefore, a legitimate consideration in the hiring of a police force.<sup>50</sup> In education, a largely male college faculty may not provide a learning environment that is as beneficial to women students as one with a substantial number of female professors.

**INJURY OBJECTION** A second utilitarian argument against affirmative action is that it injures the very people it is designed to help. The effect of hiring and promoting

minorities and women because of their race or sex is to draw attention to their lack of qualifications and create an impression that they could not succeed on their own. Another effect of affirmative action is to reduce the respect of society for the many hard-won achievements of those who qualify and to undermine their self-confidence and self-esteem. The stigma attached by preferential treatment may even have the unintended consequence of impeding racial integration if qualified minority applicants avoid jobs where race is a factor in selection.

This is an argument to be taken seriously. It rests, however, on the questionable assumption that programs of preferential treatment have not significantly helped some people. Insofar as affirmative action has boosted some racial minorities and women into higher-level positions of prestige and responsibility, there is bound to be an increase in their pride and self-respect as well as their financial well-being. Success in life is often unearned, but there is little evidence that the beneficiaries of good fortune are psychologically damaged by it. Manuel Velasquez observes, “For centuries white males have been the beneficiaries of racial and sexual discrimination without apparent loss of their self-esteem.”<sup>51</sup>

**IMPORTANCE OF RACE** The third and final utilitarian argument against preferential treatment programs is that they increase rather than decrease the importance of race and other factors in American society. If the ideal of an equal society is one in which no one is treated differently because of color, ethnic origin, religion, or any other irrelevant factor, then preferential treatment defeats this ideal by heightening our consciousness of these differences. To some critics of affirmative action, all uses of racial, ethnic,

and religious classifications are abhorrent and ultimately destructive of the fabric of a society.

One response by proponents of affirmative action is that the use of racial classifications is a temporary expedient, necessary only to eradicate racism before we can realize the ideal of an equal society. Justice Harry Blackmun wrote in an opinion:

I suspect that it would be impossible to arrange an affirmative action program in a racially neutral way and have it successful. To ask that this be so is to demand the impossible. In order to get beyond racism, we must first take account of race. There is no other way. And in order to treat some persons equally, we must treat them differently.<sup>52</sup>

The Supreme Court has long held that distinctions based on race and ethnic origin are “by their very nature odious to a free people whose institutions are founded upon the doctrine of equality.”<sup>53</sup> Nevertheless, they are permissible when the conditions warrant their use.

Others argue that there is nothing inherently wrong with race consciousness and the awareness of sexual, religious, ethnic, and other differences. What makes any of these wrong is their use to degrade and oppress people with certain characteristics. There is a great difference between the racial distinctions that were an essential element of the institution of slavery, for example, and the race consciousness that is a part of the present-day attack on racism. Any utilitarian analysis of affirmative action must take into account the history of racial and ethnic minorities and women in this country and current social realities. All things considered, the race consciousness engendered by affirmative action may be socially beneficial.

## Conclusion: Discrimination and Affirmative Action

The ethical issues surrounding discrimination and affirmative action are very problematic. Rights figure prominently in these issues—both the rights of people who have been victimized by discrimination and the rights of people who now bear the burden of correcting past wrongs. Considerations of justice also play a role. Justice requires that people who have been wronged be compensated in some way and that all people be treated equally, but the concepts of just compensation and of equal opportunity or equal treatment are subject to differing interpretations. Finally, arguments based on utility provide strong support for antidiscrimination and affirmative-action policies, although the benefits of any given policy must be weighed against the harms. The ideal of a nondiscriminatory society is clear, but the pathway to it is strewn with formidable obstacles.

### End-of-Chapter Case Studies

This chapter concludes with two case studies.

The main question posed by both cases is how to determine whether discrimination has occurred. Hostile workplace sexual harassment—as opposed to quid pro quo harassment—is usually established by patterns of offensive conduct, but these patterns may vary in the degree of offensiveness and the pervasiveness of the conduct. “Jacksonville Shipyards” asks the reader to consider whether a line has been crossed in this workplace. Sex discrimination in large businesses, such as Walmart, is commonly identified less by the treatment of individuals and more by statistical

patterns, which may be difficult to interpret. “Sex Discrimination at Walmart” illustrates the difficulty not only of interpreting statistical data but also of distinguishing other possible causes for the results found in the data.

## Case: Jacksonville Shipyards

Lois Robinson was a first-class welder at Florida-based Jacksonville Shipyards, Inc. (JSI).<sup>54</sup> Women in any skilled craft job are a rarity in the largely men’s world of shipbuilding and repair. JSI records show that between 1980 and 1987, less than 5 percent of shipyard workers were female, and no woman had ever held a supervisory or executive position at the company. Starting out as a third-class welder in 1977, Lois Robinson had steadily increased her skill so that she was the equal of any male welder. Still, she never quite fit in at JSI, which has been characterized as “a boys’ club,” where a woman could be admitted only as a sex object. She could not be accepted merely as a good welder.

None of Lois Robinson’s coworkers or supervisors had ever solicited her for sex, nor had any of them offered some benefit for her sexual favors or threatened to retaliate if she refused. Lois Robinson was occasionally ridiculed, as when one coworker handed her a pornographic magazine while those around laughed at her response, or when another coworker passed around a picture of a nude woman with long blond hair and a whip. (Because she has long blond hair and uses a welding tool known as a whip, she thought that the picture was being displayed to humiliate her.) It was not these incidents that infuriated her, however; it was rather the pervasive presence of calendars, magazines, pictures, graffiti, and other visual displays of nude women that she found intolerable.

The workplace was plastered with pinup calendars from suppliers that featured nude or partially clad women in sexually submissive poses, often with breasts and genital areas exposed. The suppliers’ calendars were distributed by JSI to its employees with permission to display them wherever they pleased. Employees were required to get permission to post any other material in the workplace—and permission was denied in some instances for requests to post material of a commercial or political nature—but pictures of nude women from magazines or other sources were displayed with the full knowledge of management, from the president of JSI down. The pictures observed by Lois Robinson included one with a woman’s pubic area exposed and a meat spatula pressed against it and another of a nude woman in full-frontal view and the words “USDA Choice.” A drawing on a dartboard pictured a woman’s breast with the nipple as the bull’s eye. Lois Robinson also became aware that the sexually suggestive comments increased when

her male coworkers noticed that she had seen one of the pornographic pictures. Although crude sexual jokes were sometimes told in her presence, she was often warned to “take cover” or leave so that the men could exchange jokes out of her hearing.

In January 1985, Lois Robinson complained to JSI management about the visual displays. Afterward, the pictures became more numerous and more graphic and the number of sexually suggestive comments to her and the other women increased. The complaints to her supervisors were apparently passed to higher levels of management, and a few pictures were removed only to be replaced by others. Some of the pictures to which she objected were in the shipfitter’s trailer, where she and other workers reported to receive instructions, and she sometimes entered the trailer to check on paperwork. One day the words “Men Only” appeared on the door of the trailer, and though the sign was soon painted over, the words could still be observed. One supervisor pointed out that the company had no policy against the posting of pictures and claimed that the men had a constitutional right to do so. The supervisor’s superior declined to order the pictures removed. Another supervisor suggested that Ms. Robinson “was spending too much time attending to the pictures and not enough time attending to her job.”

As a federal contractor (JSI performed repairs on ships for the U.S. Navy), the company is obligated by presidential order to be nondiscriminatory and to have an affirmative action plan. In 1980, JSI adopted a policy entitled “Equal Employment Opportunity.” The policy stated in part:

We should all be sensitive to the kind of conduct which is personally offensive to others. Abusing the dignity of anyone through ethnic, sexist, or racist slurs, suggestive remarks, physical advances or intimidation, sexual or otherwise, is not the kind of conduct that can be tolerated.

The policy asked that any violations be reported to the EEO coordinator at the facility. The policy was not generally known to the supervisors at the shipyards, nor was it incorporated in the standard JSI rule book. The supervisors received no training on how to deal with reports of sexual harassment or other problems, and the name of the EEO coordinator was not given in the policy and was not widely known to employees in the company. In any event, the experience of Lois Robinson was not likely to encourage any victim of harassment to make a report to anyone at JSI.

On September 2, 1986, Lois Robinson filed a suit against Jacksonville Shipyards, Inc., for sexual harassment. In the suit she cited the pervasive presence of sexually explicit pictures, the sexually suggestive and humiliating comments of her male coworkers, and the “Men Only” sign on the shipfitter’s trailer.

### SHARED WRITING: JACKSONVILLE SHIPYARDS

Why might a “reasonable person” in Lois Robinson’s situation consider Jacksonville Shipyards to be a hostile working environment? At what point did the offensive pictures, signs, and remarks cross the line from poor taste and insensitivity to sexual harassment?

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Sex Discrimination at Walmart

Betty Dukes was hired in May 1994 as a part-time cashier at a Walmart store in Pittsburg, California. Within a year she became a full-time employee, and two years later she was promoted to Customer Service Manager. Shortly thereafter, Ms. Dukes complained to the District Manager about discriminatory treatment from the head of her department and the store manager. After complaining, she was written up for a series of rules violations that were seldom enforced. In August 1999, she was demoted back to cashier, and her hours and wages were reduced. Despite this retaliation, Ms. Dukes aspired to a higher position, but each time the open position was filled without being posted, usually with a man. “Opportunities seemed to come and go, positions were filled,” she said, but managers would not provide any support or encouragement. “No one would talk to you.”<sup>55</sup>

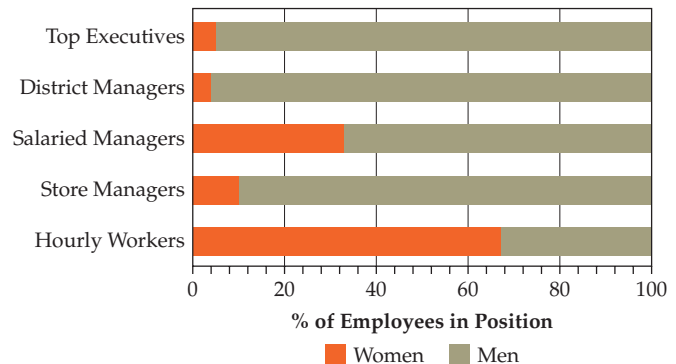
### Suing for Discrimination

On June 19, 2001, Betty Dukes joined with five other female workers to file a suit against Walmart for discriminating against them as women.<sup>56</sup> These women charged not only that local Walmart stores had discriminated against them personally but that the whole company had discriminated against all female employees during the previous five-year period. Since women employees at Walmart comprised more than 65 percent of hourly workers in a workforce of over 1 million people, the potential members of a class-action suit on behalf of all alleged victims of sex discrimination totaled at least 700,000 and possibly as high as 1.6 million women who had worked at the company for any length of time between 1996 and 2001.

Although the six women who filed the suit cited instances of discriminatory acts against themselves personally, the evidence that Walmart as a company is guilty of sex discrimination is based, in large part, on a statistical analysis of personnel data (see Figure 7.3 below). The suit alleged that female employees in Walmart stores were less likely than men to be promoted and that when they were

promoted, women’s advancement came more slowly. Women’s pay also lagged behind that of men.

**Figure 7.3** Distribution of Walmart’s Female Employees, 1996–2001



According to Walmart executives, the company has a firm policy against discrimination, and there is little evidence that individual store managers are consciously biased. The suit filed by Betty Dukes and the five other women alleged that the cause of the statistical disparities was the company’s pay and promotion practices and the discretion that store managers had in decisions about pay and promotion. Both of these factors allowed store managers to exercise an unconscious bias.<sup>58</sup> There is extensive psychological research on unconscious bias, which includes studies of stereotyping and in-group favoritism. Sex stereotyping occurs when managers evaluate female employees using traditional conceptions of the characteristics of women and the appropriate roles for them. According to one psychologist, “There are studies that show that the strongest predictor of whether an opening is filled by a man or a woman is whether the previous incumbent was a man or a woman.”<sup>59</sup> In-group favoritism is a tendency of human beings to favor those who are considered like themselves in certain respects, such as gender.

At Walmart, pay and promotion decisions were left largely to individual store managers’ discretion. This discretion on the local level was in sharp contrast to decisions on other matters, which were highly centralized at Walmart’s headquarters in Bentonville, Arkansas.

### What was the “Walmart Way” of doing most other things?

The company had uniform personnel policies and procedures for all stores in the United States on hiring, orientation, training, job assignments, pay, promotion, and discipline. The same departments, job categories, and management hierarchy were employed at all stores. Stores were linked by a sophisticated information technology system through which personnel data as well as daily reports on inventory and sales were submitted. The Bentonville headquarters carefully monitored all aspects of store operations down to temperature setting for heating and cooling systems and the selection of

music that is played in each store. The company developed a distinct corporate culture, called the “Walmart Way,” that it aggressively fostered among its employees. Employees began each day with the “Walmart cheer” (“Give me a W! Give me an A! . . .”), which was introduced by Sam Walton after he observed this practice in a Korean factory. The company culture was reinforced by evaluating employees and managers on their understanding of and commitment to the Walmart Way.

In many stores, promotion opportunities were not usually made known, and open positions were often filled with employees previously identified and groomed by store managers, whose decisions were based on vague criteria that were inconsistently applied. Many job categories and departments were identified as male or female lines of work. Women workers were typically assigned to departments such as kitchenware and children’s clothing, which were considered less important, and they were not rotated through different departments, in which they could gain valuable experience and recognition. Women who knew of vacancies said that they were not encouraged to apply, and many declined to submit an application in the belief that they stood little chance of being selected. It is alleged that men were promoted more often to positions in the same store whereas promotions involving a transfer elsewhere were offered disproportionately to women. Workers, such as Betty Duke, who complained about sex discrimination or other matters were often subjected to retaliation by store managers, which included demotions and loss of eligibility for promotions.

## Walmart’s Defense

Walmart vigorously defended itself against the charge of discrimination and has objected, in particular, to the attempt to bring a lawsuit on behalf of all women employees.<sup>60</sup> The company argued that if the six women were victims of discrimination, then the suit should seek to redress the wrongs incurred in these cases. Moreover, the circumstances in each of the six cases are different, and so the company should be allowed to defend its conduct given the particulars of each case. Walmart has further argued that as the largest private employer in the United States, with approximately 3,400 domestic stores, employing more than 1 million people, in as many as 53 departments and 170 job classifications, it is necessary to allow store managers leeway to make decisions on a case-by-case basis in response to local situations. With so many decisions to be made, some mistakes may have occurred, but Walmart insists that these were local problems that do not necessarily indicate a problem with the company’s policies and procedures.

In addition, Walmart argued in its defense that one cannot justly extrapolate from the wrongs in these six cases to the conduct of the whole company. It does not follow that because some women suffered discrimination, all women employed by the company from 1997 to 2001 were victims. This is

especially true if, as the women argue in the suit, that the discrimination occurred because of the discretion allowed to local store managers. As one observer asked, “How can a court treat 4,000 store managers as acting identically for purposes of a class action when the plaintiff’s whole theory of the case is that those store managers are being granted too much autonomy?”<sup>61</sup> Walmart has submitted evidence from its own studies that show that there are no statistically significant gender disparities in 92.8 percent of stores. These studies found that men were favored to a statistically significant degree in only 5.2 percent of stores, and that in the remaining 2.0 percent of cases, women were favored.<sup>62</sup> Thus, Walmart concludes, “The evidence establishes that, if anything, any discrimination that may have occurred was *not* system-wide, and indeed was sporadic and varied widely.”

Finally, Walmart contended that discrimination is, in large part, a problem in the larger society that the company cannot be reasonably expected to solve alone. For example, the assignment of women to certain departments, such as kitchenware and children’s clothing, may be due to their own preferences. A company spokesperson said about such cases, “Societal issues should not be confused with Walmart practices.”<sup>63</sup> In addition, women may have less interest than men in assuming a managerial position. One Walmart study further found that from 1999 to 2002, women constituted 12 percent of applicants but were offered 17 percent of the open positions.<sup>64</sup> The low ratio of women store managers may be due, then, not to company offers of the position but to women’s willingness to accept them. Furthermore, statistical disparities have many causes, some of which a company cannot easily identify and correct. Supreme Court justice Sandra Day O’Connor observed in another discrimination case, “It is completely unrealistic . . . to suppose that employers can eliminate, or discover and explain, the myriad of innocent causes that may lead to statistical imbalances in the composition of their workforces.”<sup>65</sup>

### SHARED WRITING: SEX DISCRIMINATION AT WALMART

What do you think is the most likely explanation for the conflicting statistics about female employees at Walmart? What are the problems with allowing individual store managers to use their own discretion in hiring and promoting employees? Provide a response to Walmart’s claim that the company cannot be held responsible for unconscious bias and the sexism rooted in society.

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum



# Chapter 8

# Employment Rights



## Learning Objectives

- 8.1** Recognize the three basic arguments that justify employment at will and the three types of exceptions to this doctrine that protect employees from unjust dismissal
- 8.2** Describe the main arguments and principles of the Model Employment Termination Act that support the right of employees to due process in employment decisions
- 8.3** Explain the significance of freedom of expression for employees, the extent to which it is protected by law, and the arguments for and against this right in the workplace
- 8.4** Analyze the correlation between worker participation and workplace democracy and how Dahl's argument supports workplace democracy as a right
- 8.5** Assess the market forces and other factors that influence employee compensation, the fairness of wages, and justifications for a minimum wage
- 8.6** Evaluate the reasoning underlying criticisms and justifications of the compensation for top executives

## Case: The Firing of Robert Greeley

On May 22, 1987, Robert Greeley was abruptly dismissed from his job as a laborer at Miami Valley Maintenance Contractors, Inc., in Hamilton, Ohio.<sup>1</sup> This was a blow not only to the 30-year-old, recently divorced father of two young children, but also to his ex-wife, who was relying on his job for child support payments. Three weeks earlier, a county court judge had ordered that Mr. Greeley's employer withhold the child support payments from his paycheck as permitted under Ohio law, but his bosses at Miami Valley Maintenance Contractors decided that the bookkeeping involved was too much trouble. Firing him was much easier.

Divorced fathers often fail to make court-ordered child support payments, and judges have limited means for making deadbeat dads pay. To address this problem, the U.S. Congress enacted the Child Support Enforcement Amendments of 1984, which required states to provide income withholding as a means of collecting payments. The federal law also mandated that states make provisions for fining employers who refuse to withhold such payments. The Ohio General

Assembly complied with this federal law by passing legislation the following year. An employer who violates the Ohio law is subject to a \$500 fine.

Miami Valley Maintenance Contractors readily admitted that it fired Mr. Greeley to avoid complying with the Ohio law, and it did not contest the \$500 fine. The company contended, however, that Robert Greeley, who was not a union member under a contract, was an at-will employee. Accordingly, he could leave his employment at any time, for any reason, and his employer could terminate him with the same ease.

The law in some states prohibits employers from firing for certain kinds of reasons—such as for refusing to break the law or for serving on a jury—because permitting them to do so conflicts with important matters of public policy. However, Ohio was, at the time, a strict employment-at-will state. Employers could hire and fire at will, with virtually no legal restrictions. In 1986, for example, the state supreme court upheld the firing of a Toledo-area chemist who reported illegal dumping of toxic wastes, even though the employer was eventually found guilty and fined \$10 million by the Ohio Environmental Protection Agency. By comparison, Mr. Greeley's employer got off cheaply: The company had to pay a paltry \$500 fine for the privilege of firing him.

## Points to Consider. . .

At first glance, there is nothing remarkable about the case of Robert Greeley. In the United States, employers are generally regarded as having the right to make decisions about hiring, promotion, and discharge, as well as wages, job assignments, and other conditions of work. Employees have the corresponding rights to accept or refuse work on the terms offered and to negotiate for more favorable terms. But in the absence of a contract that spells out the conditions under which employment can be terminated, employees can be legally dismissed for any reason—or for no reason at all.

Some critics hold that certain reasons for dismissal are morally unacceptable, given that losing a job is often one of the most traumatic occurrences in people's lives. Aside from the interruption of income and benefits, dismissed workers typically lose a valued social network and an important source of satisfaction and meaning. Even when a terminated worker finds another job quickly, the new position may pay less than the old one, with the result that lifetime earnings are reduced. Thus, job security is an important aspect of employment that workers value and often seek in a job.

Another argument is that employees should be dismissed only for good reasons, or those which are generally considered to be just grounds for dismissal. Such just reasons or grounds include economic adjustments, as when an employer has too many workers or workers without the right skills, inadequate job performance, and inappropriate or disruptive behavior on the job. Many people also believe that, whatever the reason, employees should be informed of the grounds for their dismissal and have an opportunity to offer a defense.

Dismissal is widely considered to be unjust, then, under two conditions: when an employee is dismissed without a good cause and when the dismissal occurs without a fair hearing. These two elements together constitute *due process*. Although due process is a requirement of the criminal justice system, in which the state prosecutes persons for crimes, it is less clear that justice requires due process in employment.

A person should not be sentenced to prison or otherwise punished by the state without due process, but is the same true in employment when a worker is dismissed?

In general, American labor law has adopted a doctrine of *employment at will* that gives employers wide latitude in dismissing or terminating workers such as Robert Greeley. Thus, the issue of unjust dismissal raises two questions. One question concerns the conditions under which the dismissal of employees is morally justified. Is due process a *moral* requirement for just dismissal? The other question is, even if it is a moral right, should due process be a *legal* requirement and thus have the force of law?

This chapter addresses the ethical questions surrounding employment at will, unjust dismissal, and these other important employee rights:

- the right to freedom of thought and expression in the workplace,
- a right to participate in workplace decisions (especially those that affect employees), and
- certain rights with regard to compensation.

Among the moral issues in compensation practices are the adoption of a legal minimum wage and the higher standard of a fair or “living” wage, as well as the controversy over executive compensation. This list of employee rights is not exhaustive. However, other rights that employees have in the workplace—including rights involving privacy, discrimination, whistle-blowing, and occupational health and safety—are covered in other chapters.

## 8.1: Employment at Will

### 8.1 Recognize the three basic arguments that justify employment at will and the three types of exceptions to this doctrine that protect employees from unjust dismissal

In the American legal system, a cornerstone of labor law is the doctrine of employment at will, according to which an employer may terminate an employee at any time and for any reason unless an employment contract specifies otherwise. Employment, according to this doctrine, is an “at-will” relation that comes into existence when two parties willingly enter into an agreement, and the relation continues to exist only as long as both parties will that it does so. Both employers and employees have the right to enter into any mutually agreeable arrangement without outside interference. Each party is also free to end an arrangement at any time without violating the rights of the other, as long as doing so is in accord with the terms that they have agreed on.

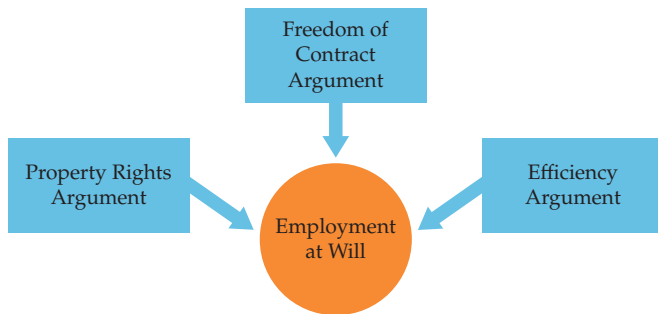
The first explicit statement that employment is an at-will relation occurred in an 1877 work by Horace G. Wood entitled *A Treatise on the Law of Master and Servant*.<sup>2</sup> The doctrine was first given legal force by an 1884 Tennessee Supreme Court decision in the case *Paine v. Western & A.R.R.* In an often-quoted passage, the court declared,

Men must be left, without interference . . . to discharge or retain employees at will for good cause or for no cause, or even for bad cause without thereby being guilty of an unlawful act per se. It is a right which an employee may exercise in the same way, to the same extent, for the same cause or want of cause as the employer.<sup>3</sup>

Other state courts followed the example of Tennessee, as did the U.S. Supreme Court, so that shortly after the turn

of the century, the doctrine of employment at will was firmly established in American law. However, the United States is virtually alone among the countries of the world in its adoption of employment at will; most other parts of the world, most notably Europe and Japan, place narrow limits on the legal power of employers to terminate employment.

**Figure 8.1** Arguments Used to Justify Employment at Will



Three arguments are commonly used to justify employment at will.

- One argument holds that the doctrine is entailed by the rights of property owners.
- The second argument appeals to the notion of freedom of contract.
- The third argument is based on considerations of efficiency.

### 8.1.1: Property Rights Argument

The property rights argument begins with the assumption that both employers and employees have property of some kind. The owner of a factory, for example, owns the machinery and raw materials for the manufacture of a product, along with a certain amount of money for wages. The remaining resource is labor for operating the machinery and turning the raw materials into a finished product. Labor, or more precisely the productivity of labor, thus has an economic value and can be said to be a kind of “property” that is “owned” by the worker. Employment can be described, therefore, as an exchange of a worker’s productive power for the wages that are given out in return by the factory owner.

In this exchange, both parties are free to exercise the rights of property ownership. The owner of the factory is free to utilize the productive resources of the factory and to pay out money as wages in any way that workers are willing to accept. Workers are free to accept work under the conditions and at the wages offered or to seek work elsewhere on more favorable terms. It follows that any restriction on the kinds of agreements that employers and employees can make is a violation of the property rights of both parties. Just as consumers are under no obligation to continue buying a product, employers are free to stop “buying” the labor

of an employee. Although the loss of a job may create some hardship for the person dismissed, no rights are violated according to the property rights argument; indeed an important right, the right to property, is respected.

The historical roots of the property rights argument are contained in John Locke’s idea that there is a natural right to property, by which he meant a morally fundamental right that exists apart from any particular legal system. Accepting the biblical belief that God gave the bounty of the earth to all persons in common for the purposes of life, Locke went on to observe that we can make use of this bounty only by appropriating it and making it our own. The fruit of a tree cannot nourish us, for example, until we pluck and eat it, but when one person eats a piece of fruit, that person deprives another of its use. Locke’s argument for property as a natural right is based, therefore, on the role that property, including labor, plays in satisfying human needs.

The argument for employment at will based on property rights assumes that the value of these rights has supreme importance and benefits both employers and employees. All rights are limited, however, for the simple reason that they inevitably come into conflict with each other and with important societal interests. Thus, it may be argued that employment at will, far from enhancing employers’ and employee’s property rights, undermines them, or otherwise works to the detriment of everyone’s well-being.

In particular, property rights are fundamental in Locke’s political theory because of the role they play in satisfying our basic needs and securing liberty. It can be argued, however, that instead of serving these Lockean ends, the doctrine of employment at will has the opposite effect, namely, impoverishing workers and subjecting them to the will of others. Property rights have the potential to enable employers to benefit at the expense of employees and to exercise not merely economic but also political power over them. Philip J. Levine argues that this “subjugation of the working class” is made worse by the fact that a job is often a person’s only means of support and the basis for his or her position in society. He continues, “The essential elements of life are all dependent on his ability to derive income.”<sup>4</sup>

This objection rejects the basic assumptions of the property rights argument for employment at will—namely, that employment at will works to the benefit of employees as well as employers, and that employees are able to contract away from this system should it not be to their advantage. Critics also question an underlying assumption of the property rights argument, namely, that employment involves an exercise of property rights at all. As previously noted, employment at will is a distinctively American doctrine, and the law in Japan and most countries of Europe gives workers considerably more job security. Clyde W. Summers notes,

“In other countries, employees are viewed as members of the business enterprise.” In the United States, he observes, “the employee is only a supplier of labor who has no legal interest or stake in the enterprise other than the right to be paid for labor performed.”<sup>5</sup>

For critics like Summers, the flaw in the doctrine of employment at will is the framing of the employment relation as an economic transaction involving an exchange of property between employers and employees. More appropriate, in their view, is a conception, common in Japan and Europe, of a firm as a community to which employees belong as members. As members of a community, employees cannot be dismissed unilaterally by an employer but must be allowed some fair procedure in cases of termination.

### 8.1.2: Freedom of Contract Argument

In the freedom of contract argument, employment is viewed as a contractual arrangement between employers and employees. This arrangement arises in some instances from an explicit contract, a legal document signed by both parties, in which a business firm states the terms under which it is willing to hire a person and that person signifies by his or her acceptance a willingness to work under those terms. Union employees are typically covered by a company-wide contract that is agreed to by both the management of a company and the union rank and file. In the absence of an explicit contract, we can still understand the employment relation as involving an implicit contract insofar as the conditions of employment are understood and tacitly accepted by both parties.

To place a limit, then, on the kinds of agreements that can be made between an employer and an employee is to violate the freedom of contract of both parties. Just as it would be a violation of an employee’s freedom of contract to force an employee to remain in a job, so it would be a violation of the employer’s freedom of contract to prevent an employer from terminating an employee who voluntarily entered into an at-will employment relation. This reasoning is employed in a Supreme Court decision upholding the right of an employer to fire an employee for belonging to a labor organization.

#### How did the court majority explain freedom of contract as a right?

##### Read the Supreme Court’s majority opinion

The majority opinion in this case, *Adair v. United States* (1907), held:

[I]t is not within the functions of government—at least in the absence of contract between the parties—to compel any person, in the course of his business and against his will, to accept or retain the personal services of another,

or to compel any person, against his will to perform personal services for another. The right of a person to sell his labor upon such terms as he deems proper is, in its essence, the same as the right of the purchaser of labor to prescribe the conditions upon which he will accept such labor from the person offering to sell it. So the right of the employee to quit the service of the employer for whatever reason is the same as the right of the employer, for whatever reason, to dispense with the services of such employee. . . . In all such particulars the employer and the employee have equality of right, and any legislation that disturbs that equality is an arbitrary interference with the liberty of contract which no government can legally justify in a free land.<sup>6</sup>

In another case the Court held, “This right is as essential to the laborer as to the capitalist, to the poor as to the rich; for the vast majority of persons have no other honest way to begin to acquire property, save by working for money.”<sup>7</sup>

In the British and American legal traditions, the philosophical basis for the freedom of contract argument, as for the property rights argument, derives from John Locke, who considered the exercise of a right to contract as part of a more general freedom of action. On the European continent, however, the philosophical basis for freedom of contract derives not from Locke but from Immanuel Kant and his concept of autonomy. The Kantian argument can be sketched briefly as follows:

Autonomy involves the capacity and opportunity to make meaningful choices about matters that bear most significantly on our lives.

That is, we are autonomous insofar as it is we who make the important decisions affecting our lives and not others. An essential part of acting autonomously in this sense is the possibility of making mutually binding voluntary agreements. Therefore, autonomy entails freedom of contract.

The rights-based argument for employment at will is criticized for overemphasizing freedom of contract. Taken to an extreme, freedom of contract is incompatible with any worker-protective legislation, including laws that limit workers’ hours and require a minimum wage. This conflict between freedom of contract and worker protection was at issue in *Lochner v. New York*, which involved an 1897 New York statute limiting the work of bakers to 10 hours a day and 60 hours a week.<sup>8</sup> The law was intended to protect the health of bakers, which was being undermined by the long, exhausting hours they were required to work. This piece of protective legislation was struck down by the U.S. Supreme Court in 1905 on the grounds that it violated the right of bakers and bakery owners alike to contract on mutually agreeable terms. According to the majority opinion, “the freedom of master and employee to contract with each

other in relation to their employment . . . cannot be prohibited or interfered with, without violating the Federal Constitution.”

The freedom of contract argument for employment at will is problematic because of the immense difference in bargaining power that usually prevails between employers and employees. Bargaining almost always takes place between parties of different strengths, and the stronger side usually gains at the expense of the weaker. The outcome need not be unjust for this reason, but the possibility raises the following question:

Is there some point at which employers ought not to be permitted to take advantage of their superior bargaining position?

The decision in *Lochner v. New York* denied that there was any morally significant difference in bargaining strength between bakery workers and their employers. However, the *Lochner* era came to an end in 1937 with the decision in *West Coast Hotel v. Parrish*.<sup>9</sup> Chief Justice Hughes, who delivered the majority opinion, cited “an additional and compelling consideration which recent economic experience has brought into a strong light.” This consideration is the “exploitation of a class of workers who are in an unequal position with respect to bargaining power and are thus relatively defenseless against the denial of a living wage.” The doctrine of employment at will cannot be justified by a right to freedom of contract, according to Chief Justice Hughes, when the result is to deprive employees of the ability to protect their most vital interests. This decision was followed by a series of federal and state worker-protection laws that addressed the most serious abuses of employment at will.

#### **How then can the freedom of contract argument still be used to support employment at will?**

Except for the position that the employment relation should not be viewed as a matter of contract at all, these objections to the freedom of contract argument do not undermine the doctrine of employment at will but only support restrictions or conditions on its application. Employment at will is a default legal rule, which is to say that it applies unless employers and employees contract differently. Many American employees, including all union workers, have employment contracts that specify the conditions for termination and the procedure to be followed. Employment at will does not, in any way, hinder such contracts and, indeed, invites them. Moreover, there is much legislation that limits the power of employers over employees. If employers gain too much power over employees because of employment at will, legislators can offset this power, either directly by regulating working conditions or indirectly by promoting collective bargaining, for example. Such remedial legislation might be a better solution to the undesirable consequences of employment at will than the elimination of the doctrine outright.

### 8.1.3: Efficiency Argument

The third argument for employment at will is a utilitarian one that relies not on property rights or the freedom of contract, but on the importance of the employment-at-will doctrine for the efficient operation of business, which benefits both employers and employees, as well as society generally. Although employment at will is often thought to be something that employers impose upon employees without their consent, the contractual nature of employment requires that the terms of employment be mutually advantageous. Given freedom of contract, employers and employees who find mutual benefit in job security and protection from dismissal will contract away from employment at will. However, when both parties agree to employment at will, we must assume that such an arrangement benefits both employers and employees. The mere fact that employment at will persists when employers and employees could contract on other terms demonstrates its advantages for all concerned.

The utilitarian advantages of employment at will to employers are straightforward.<sup>10</sup> The success of any business enterprise depends on the efficient use of all resources, including labor. For this reason, employers should generally be accorded considerable leeway to

- determine the number of workers needed,
- to select the best workers available,
- to assign them to the jobs for which they are best suited, and
- to discipline and dismiss workers who perform inadequately.

Under employment at will, business decisions can be made quickly and at low cost. By contrast, legal restrictions on employment decisions not only add costs, including those of forgone opportunities and the expenses of litigation, but they also put legislatures and courts in the position of making business decisions, which increases the complexity of business operations. Furthermore, an employer with an inflexible workforce must plan more carefully for the future and attempt to anticipate changing circumstances and new opportunities, which may be difficult due to lack of foreknowledge. Overall, the intrusion of factors other than the most efficient allocation of resources into business decision making can only impair efficiency, according to this argument, and thereby harm everyone concerned.

How do employees benefit from employment at will?

- First, workers at efficient companies will have better job prospects with higher pay due to the ability of the employer to adapt to changing circumstances and exploit new opportunities. Such firms will better utilize the talents and skills of their employees, which makes them more productive and hence able to earn higher compensation.

**Table 8.1** Arguments Supporting Employment at Will

Review the main arguments for employment at will, the premise or underlying principle for each and how it supports the doctrine. Hide the cells in the table to quiz yourself.

Argument	Premise	Implications
Property Rights Argument	Both employers and employees have “property” of some economic value and the right to determine what they do with their own property.	Employers have wages and employees have labor. They are free to buy and sell this “property” or accept and refuse offers for it.
Freedom of Contract Argument	Employment is a contractual arrangement between employers and employees. Both have the right to contract as they choose.	Excessive limits on the agreements that can be made between employers and employees violate their freedom to contract.
Efficiency Argument	When employment at will is chosen by employers and employees it is mutually advantageous.	Employment at will enables a more efficient operation of business, which benefits employers, employees and society.

- Second, without employment at will, legal restrictions on dismissal will create a rigid workforce in which employees cannot easily change jobs and become trapped in the ones they have. Such job immobility, which is prevalent today in Japan and Europe, has several adverse consequences for employees.

### What are the consequences of job immobility?

**One consequence of low job mobility** is that employers can make greater demands on and even abuse workers who cannot readily move to another job. In a more open job market, where employees can simply quit, the freedom of employers to be overly demanding or abusive is sharply limited. High job mobility also restricts the freedom of employers to fire without due process, because valued employees who perceive any dismissals to be arbitrary or unfair may respond by reducing their commitment to the company and seeking jobs elsewhere. Any employer who abuses the legal right to dismiss at will pays a high price in the market, and this market price may deter such abusive behavior more effectively than any legal sanction can.

**Another consequence of reduced job mobility** is that workers are less able to migrate to better job opportunities in which they can be more productive. If a worker is likely to stay at any job for a lifetime, then the choice of a first job is critical, and yet no worker has the ability to predict how he or she could be best employed far in the future. The job mobility provided by employment at will thus protects workers from being disadvantaged by their lack of foreknowledge.

Table 8.1 summarizes the three arguments commonly used to justify the employment-at-will doctrine.

### WRITING PROMPT

#### Evaluating Employment-at-Will Arguments

What are some counterarguments to the property rights, freedom of contract, and efficiency arguments for employment at will? Explain what you think is the strongest objection to the employment-at-will doctrine.

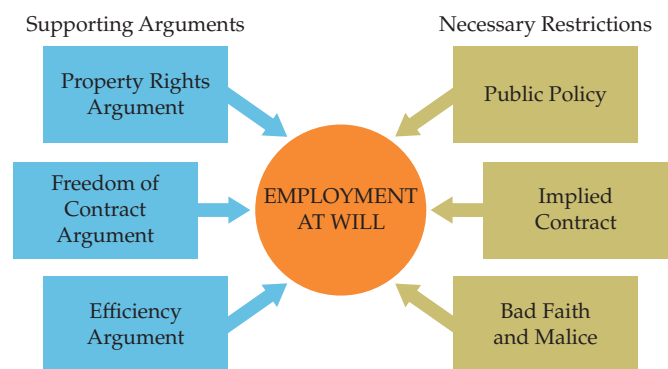
▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

### 8.1.4: Exceptions

These three arguments—based on property rights, freedom of contract, and efficiency—not only provide some grounds for justifying employment at will but also support some limitations or restrictions. The rights to own property and to contract freely are not unlimited; when they conflict with other rights or goods, some adjustments must be made. Furthermore, the utilitarian benefits of employment at will may be outweighed, in some instances, by the harms resulting from the unrestricted application of this legal doctrine. Accordingly, the courts have carved out exceptions to employment at will under three broad heads, as shown in Figure 8.2: public policy, implied contract, and bad faith and malice.

**Figure 8.2** An Acceptable Employment at Will Doctrine



**PUBLIC POLICY** The courts have held that at-will employees must be protected in the following three ways, on grounds of good public policy.

**First, employees ought not to be subject to discipline, demotion, or discharge for refusing to violate the law.** If anything is contrary to public policy, it is a doctrine that permits employers to use the threat of dismissal to force an employee to commit illegal acts. In a 1959 California case, *Petermann v. International Brotherhood of Teamsters*, the business manager for a local of the Teamsters union was fired by the union after he refused an order to commit perjury before an investigative committee of the state legislature.<sup>11</sup> The California Court of Appeals held that in order to make

the law against perjury effective, some restriction had to be placed on an employer's right of discharge.

**Second, employers ought not to prevent employees from receiving the full benefit of their legal rights and entitlements relating to employment.** The legislation creating many employee rights includes antiretaliation provisions, so there is no need for the courts to create a separate public-policy exception. Thus, the National Labor Relations Act and the Occupational Safety and Health Act, among others, not only forbid retaliation but also provide for legal remedies. However, some employees have been dismissed for asserting legal rights for which the law does not provide antiretaliation protection. One such right is filing workers' compensation claims for injuries suffered on the job. In one workers' compensation case, the court ruled, "When an employee is discharged solely for exercising a statutorily conferred right, an exception to the general rule [of employment at will] must be recognized."<sup>12</sup>

**Third, an employer's right to dismiss at will should not interfere unduly in the ability of government to promote social welfare.** For example, when an employee was dismissed for being away from work to serve on a jury, an Oregon court held that the discharge was for "a socially undesirable motive" that tended to "thwart" the jury system, thus undermining the administration of justice.<sup>13</sup> In the case of Robert Greeley, the Ohio Supreme Court held that ensuring that the children of divorced parents are properly supported is an important matter of public policy, and that the means devised by the Ohio state legislature—namely, ordering employers to withhold child support payments from a parent's paycheck—is a reasonable means of achieving this policy objective. Allowing employers to ignore a court order merely by paying a small fine would undermine the child support enforcement mechanism created by the state legislature. The state legislature established a policy, and a justice of the state supreme court said, "It is our job to enforce, not frustrate, that policy."<sup>14</sup>

**IMPLIED CONTRACT** A second set of exceptions to employment at will involves the existence of an implied contract that contains different terms. In some instances, prospective employees are given assurances in job interviews that dismissal is only for cause, that attempts are made to work through any problems before the company resorts to dismissal, and that due process is followed in all cases. These assurances are conveyed in other instances by employee manuals, policy statements, personnel guidelines and procedures, and other company documents. The claim that an implied contract exists as a result of different kinds of assurances makes an appeal, not to a utilitarian justification based on public policy, but to the law of contracts.

In two Michigan cases that were decided together, *Toussaint v. Blue Cross and Blue Shield of Michigan* and *Ebling v. Masco Corporation*, the plaintiffs were given assurances of

job security by their employers as long as they performed satisfactorily.<sup>15</sup> Charles Toussaint testified that he was told by his employer that he would be with the company until the mandatory retirement age of 65 "as long as I did my job." The supervisory manual at Blue Cross and Blue Shield stipulated that employees could be dismissed only for just cause and that specific disciplinary proceedings were to be used. The court found that his supervisor, in asking him to resign, had not observed these provisions in the manual. Furthermore, the court held,

While an employer need not establish personnel policies or practices, where an employer chooses to establish such policies and practices and makes them known to its employees, the employment relation is presumably enhanced. The employer secures an orderly, cooperative and loyal work force, and the employee the peace of mind associated with job security and the conviction that he will be treated fairly.

**BAD FAITH AND MALICE** Even without an implied contract, a commonly accepted principle in business is acting in good faith. This concept is applied widely as both a moral and a legal requirement in collective bargaining, contract negotiations, consumer relations, and indeed virtually all commercial dealings. An example of conspicuous bad faith is the case of a 25-year veteran employee of the National Cash Register Company, named Fortune, who was dismissed the next business day after he had secured an order for \$5 million worth of equipment to be delivered over the next four years. The court found that the dismissal was motivated by a desire to deprive Fortune of the very substantial commission he would receive as the equipment was sold. The Massachusetts court held that Fortune had an implied contract with his employers and stated that "in every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing."<sup>16</sup>

In general, the courts have been reluctant to make exceptions to the doctrine of employment at will, placing limits only in cases where employer behavior significantly impacts good public policy or violates recognized legal norms. Although these exceptions reduce the freedom of employers to dismiss at will, they strengthen the doctrine of employment at will by making it more acceptable and predictable.

## 8.2: Right to Due Process

### 8.2 Describe the main arguments and principles of the Model Employment Termination Act that support the right of employees to due process in employment decisions

Objections to employment at will have been raised on many different grounds. Some critics would merely modify the

doctrine by creating more exceptions, such as protection for freedom of speech in the workplace, which is considered in the next section. Indeed, many other laws, such as those prohibiting discrimination and unsafe working conditions, already restrict the right of employers to dismiss at will by specifying reasons for which an employee cannot be dismissed. Other critics question whether the arguments for employment at will based on property rights and freedom of contract support the doctrine. However, the main source of opposition to employment at will has come from critics who maintain that employees have a moral right to due process in employment decisions that is incompatible with this legal doctrine. Thus, the main alternative to employment at will is a legally recognized right to due process.

The term “due process” occurs in the Fourteenth Amendment to the U.S. Constitution, which provides that no state shall “deprive any person of life, liberty, or property without due process of law.” In this political context, due process is a check on the arbitrary exercise of government power: The state may not use its considerable power in ways that harm citizens in important respects without adequate justification. This justification consists not only in having an adequate *cause* or good reason for the state’s action but also in following fair or just *procedures*. The concept of due process in employment is similar to its application in a political context. Employers have less power than government to adversely affect individuals, but termination of employment, in particular, can still inflict grievous harm on workers. Due process in employment, then, restricts the right of an employer to dismiss an employee without having a just cause and without following just procedures.

### 8.2.1: Support for Due Process

Three broad arguments are offered in support of a right to due process.

**First, it is argued that a terminated employee suffers some substantial harm that ought not to be inflicted without an adequate reason and a fair hearing.** If comparable jobs were readily available, then no employee would be harmed by being forced to change; but when jobs are scarce and the alternatives are less desirable, the loss of a job is a significant financial blow. In addition, our social standing and self-esteem are closely linked to our work, so that a job loss may also result in some psychological harm. Because a job is so essential to our well-being, it should not be subject to the arbitrary power of an employer. Employers have great power over us, and this power should be exercised responsibly. A law that requires employers to have a good reason and provide a fair hearing for any dismissal is reasonable, then, in view of power that they hold.

**A second argument for a right to due process is that this right is owed out of respect for the dignity of workers.** Tara J. Radin and Patricia H. Werhane argue,

Employees are human beings, with dignity and emotional attachments, not feelingless robots. This is not to say that inadequate employees should not be replaced with better performers, but employees at least deserve to find out the reasons for underlying employment changes. And if employees are to take charge of their careers, they should receive good reasons for employment decisions and full information.<sup>17</sup>

Some writers argue that employers ought to enable workers to keep their knowledge and skills up to date so that they can easily move to other jobs in the event of job loss. Rosabeth Moss Kanter contends that although employers cannot and should not be expected to provide job security, they have a duty to give workers what she calls “employability security,” which is a matter of providing work that “will enhance the person’s value in terms of future opportunities.”<sup>18</sup>

**Third, some proponents of a right to due process argue that treating employees fairly is simply good management practice that pays off in increased productivity.** Although job security alone is unlikely to have much effect, there is considerable evidence to show that worker participation in all aspects of a firm’s operations enhances productivity and that some measure of job security is essential for gaining the benefits of greater employee involvement.<sup>19</sup> One objection to this efficiency-based argument is that if according employees due process has productivity gains, then employers do not need a legal requirement to do this; the market alone will provide adequate incentives to secure due process. Thus, if employment at will is the default legal rule, employers and employees will contract away from this situation in order to gain the benefits of greater job security. John J. McCall addresses this objection by arguing that the efficacy of such contracting depends on what is the default legal rule, and that having employment at will “as the background default rule may actually inhibit an efficient bargaining outcome.”<sup>20</sup>

The debate over the efficiency of employment at will and due process or job security as default rules is not easily resolved. In general, the argument that employment at will is a more efficient default rule rests on the assumption that employers and employees are fully rational and well-informed and so can bargain effectively, whereas the argument for due process questions whether the two parties can bargain rationally with full information.

### 8.2.2: Law of Due Process

The effect of a law that ensured due process would be to introduce the legal right not to be dismissed without cause and a fair hearing into every employment relation. This right would be guaranteed for all employees and would not depend on an explicit contract and the implied covenant of good faith and fair dealing that currently constitute



exceptions to employment at will. Such a right is meaningful only if there are mechanisms in place for hearing employee complaints and providing a remedy. The remedy should not only provide full compensation for an employee's loss but also constitute an effective deterrent to employers' dismissing employees unjustly. In short, a right against unjust dismissal is effective only if any wrong committed in discharging an employee is rectified and the incidence of such wrongdoing is minimized.

The Model Employment Termination Act has been proposed as a guide for the development of state laws.<sup>21</sup> Since its drafting in 1991, no state has chosen to follow the lead of this document. Montana had previously adopted a just-cause statute in 1987 and today remains the only state to depart from employment at will. This Act can serve to illustrate the difficulties involved in legislating a right to due process in the termination of employment.

The key proposal in the Model Employment Termination Act is that an employer may not terminate the employee without "good cause," which is defined as:

- (i) a reasonable basis for the termination of an individual's employment in view of the relevant factors and circumstances, which may include the individual's conduct, job performance and employment record; and the appropriateness of termination for the conduct involved; or
- (ii) the good faith exercise of business judgment, which may include setting economic goals and determining methods to achieve those goals, organizing or reorganizing operations, discontinuing or divesting operations or parts of operations, determining the size and composition of the workforce, and determining and changing performance standards for positions.

This definition conforms to the concept of "good cause" that has evolved in decades of labor union arbitration, and it does not interfere with decision making on the basis of legitimate business considerations, as long as these are in good faith. Among the potential difficulties of the definition is determining whether an exercise of business judgment is in good faith. For example, an employer might raise the standards of performance merely in order to dismiss a particular employee. In a unionized setting, any raising of standards would be subject to negotiation, but a nonunion worker would have no similar protection.

The Model Employment Termination Act also contains a waiver provision under which an employee can waive the right not to be dismissed without cause in exchange for the employer's agreement to make a severance payment equal to one month's salary for every year of service. The danger of this provision is that an employer might require all employees to sign a waiver as a condition of employment. Doing so would effectively deprive employees of the option to pursue legitimate termination complaints in court, with the possibility of obtaining a high award, and,

at the same time, it would protect employers from court litigation and the risk of paying high awards.

Two final issues concern the method of resolving disputes and the remedy. The Model Employment Termination Act recommends arbitration as the preferred dispute-resolution method and reinstatement with lost pay as the preferred remedy. Arbitration works well in a unionized setting, where it often serves as an extension of union-management negotiation and involves the terms of a master contract. Without this context, arbitrators would have little guidance for resolving disputes. Reinstatement, too, is an appropriate remedy only in a unionized setting where the union is able to protect reinstated employees from subsequent retaliation. In addition, reinstatement with lost pay would not constitute a significant deterrent to employers. An alternative to state laws that follow this Act is a federal statute modeled on Title VII and other antidiscrimination laws, which provides for court action and monetary compensation.

#### WRITING PROMPT

##### Unjust Dismissal

Review the definition of a "good cause" for dismissing employees. The Model Employment Termination Act is thought to effectively balance employees' right not to be wrongfully fired with the right of employers to dismiss those who fail to do their job. Explain whether you think this Act achieves the balance it seeks. How does the right to arbitration outside of court help the average, non-unionized employee to contest a potentially wrongful termination?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 8.3: Freedom of Expression

### 8.3 Explain the significance of freedom of expression for employees, the extent to which it is protected by law, and the arguments for and against this right in the workplace

Expressing one's views at work or even away from the job can be hazardous. Employees have been disciplined and even dismissed for their opinion of their bosses and their decisions, for complaints about compensation or working conditions, for their support or lack of support for political candidates or issues, for a refusal to make political contributions, for their advocacy of a union, for their published writings, for holding public office, and, indeed, for the expressions of almost any views that offend their superiors. Related to freedom of expression is freedom of conscience, which has led some employees to refuse to perform parts of their job which they consider to be morally wrong. For example, some pharmacists have cited a right of

conscience in refusing to fill prescriptions for birth control drugs or the so-called “morning after” pill.<sup>22</sup>

David C. Yamada argues that there are “disturbing signs of a severe chill” on expression in today’s business world, which are due to a number of features in the postindustrial workplace.<sup>23</sup> He writes,

In essence, today’s American workplace is evolving into an institution in which the expression of an individual employee is severely devalued. The unstable, downsizing nature of today’s economy has made workers feel insecure about keeping their jobs, contributing to self-censorship in the workplace and a reluctance to initiate collective action. . . . Workers generally are spending more time on the job, thus taking away time that could be devoted to cultural self-expression and civic activities. This is occurring at a time when companies themselves are becoming *more* vocal about issues of social concern, often in ways that suggest that going along with an employer’s social views help to guarantee one’s continued employment.<sup>24</sup>

Issues about freedom of expression overlap with those in whistle-blowing, since whistle-blowers issue warnings about potentially harmful corporate activities. Firing or disciplining employees for their expression of views outside the workplace might also be considered a violation of a right to privacy. When at-will employees suffer adverse personnel consequences for expressing themselves, then questions arise about the justification of such treatment under the legal doctrine of employment at will, which is discussed earlier in this chapter. Any legal protection for at-will employees who speak out would add a further exception to the rights of employees under this doctrine. Still, freedom of expression raises issues that extend beyond these other matters and merit a separate discussion.

### 8.3.1: Defining Freedom of Expression

A definition of freedom of expression includes four elements:

1. the nature of the expression (whether it is speech, writing, or symbolic acts);
2. the subject or topic of the expression (whether it is about the workplace or unrelated matters);
3. the location or venue of the expression (whether it takes place in or outside the workplace); and
4. the audience of the expression (whether it is made in private to a few people or publicly declared to many).<sup>25</sup>

Consider the following corresponding points.

1. First, one can express oneself not only in speech and writing but also through symbolic acts, such as wearing a campaign button or refusing to participate in certain activities. For example, a factory worker for a

defense contractor was fired for stomping on an American flag and then blowing his nose into it after refusing to display the flag at his workstation during a Gulf War celebration.<sup>26</sup> The Connecticut Supreme Court ruled that the employee’s symbolic actions were not protected by the state’s free speech law.

2. Second, an employee can express views about not only the workplace but matters wholly unrelated to it, such as social or political affairs or current events.
3. Third, the expression, whether work related or not, may take place completely away from the workplace on an employee’s own time.
4. And, finally, the expression may be made only to one or a few people in or out of the workplace or to the public at large in a publication or another public forum. The possibilities for public dissemination of one’s views have been greatly expanded by advances in information technology, including e-mail and Web-based communication. For example, a number of people have been fired for comments about an employer in posts on their personal blogs.<sup>27</sup>

Freedom of expression can be defined narrowly or broadly. It might be restricted to the expression of views about the workplace in the workplace. A broad definition, offered by Bruce Barry, is that workplace freedom of expression is the ability to engage in acts of expression, which may be written, spoken or symbolic, made in public or private, “at or away from the workplace, on subjects related or unrelated to the workplace, free from the threat of formal or informal workplace retribution, discipline, or discharge.”<sup>28</sup>

### 8.3.2: Legal Protection for Expression

Legal protection or the lack of protection for freedom of expression in the workplace in the United States is due to two separate provisions of American law. One is the First Amendment guarantee of free speech and the other is the doctrine of employment at will. In addition, freedom of expression for whistle-blowers is provided by many federal, state, and municipal legislative acts concerning such matters as collective bargaining, environmental protection, worker health and safety, government procurement, and securities fraud. Some states have passed so-called “privacy laws” that prohibit an employer from firing or refusing to hire a person for engaging in legal activities away from the job.<sup>29</sup>

Although free speech is guaranteed by the U.S. Constitution and the constitution of every state, this right protects only citizens against state action and not the action of private individuals or organizations. Thus, it is illegal for the government to limit people’s expression, but the

Constitution places no restriction on the actions of private businesses. As a result, public and private employers and employees are treated differently under the law.

### Whose freedom of speech is protected on and off the job?

Government employees have recourse in federal and state courts when their employer, which is to say the government, dismisses or otherwise sanctions them for expressing their views, but employees of corporations in the private sector have no constitutionally guaranteed free-speech protection.

The courts have recognized a right of free speech for public employees under the First Amendment.

**Example:** A public school teacher in Illinois wrote a letter to the editor of a local newspaper, criticizing the school board for favoring athletics at the expense of the academic program. The teacher, named Marvin Pickering, was fired on the grounds that writing the letter was “detrimental to the efficient operation and administration of the schools of the district.” Pickering charged in reply that writing the letter was an exercise of the First Amendment right of free speech that cannot be denied citizens just because they are government employees. The U.S. Supreme Court agreed with Pickering and thereby established free-speech protection for government employees.<sup>30</sup> *Holodnak v. Avco Corporation* (1975) extended the precedent set by *Pickering* to private employers who do extensive work for the federal government.<sup>31</sup>

The free-speech right of government employees is not unlimited. In general, the courts have employed a balancing test that weighs the value of freedom of expression when a government employee speaks out on a matter of public concern with the need of government agencies to maintain order and efficiency in the workplace.

**Example:** In *Connick v. Myers*, a New Orleans prosecutor was fired when she distributed a questionnaire to her coworkers to protest a personnel matter. The U.S. Supreme Court ruled that the “speech” in question, namely the distribution of the questionnaire, did not address a matter of “public concern” sufficient to override the interest of the employer in maintaining control and efficiency in the workplace.<sup>32</sup> However, along with greater freedom of expression on some matters, government employees face some restrictions on partisan political activity that are not placed on private sector employees.

Employees in the private sector have a right to expression insofar as such a right is contained in employment contracts. Tenured university professors have perhaps the strongest contractually guaranteed right to express their views, though some instances of free speech (proselytizing

in the classroom, for example) are not protected. Contracts with due-process provisions, which are typical of union contracts, do not usually specify freedom of expression, but an exercise of free speech would usually not constitute a “good cause” for dismissal or discipline. In a fair hearing that would occur when a contract has a due-process provision, there is usually the same kind of balancing test that is applied in public-sector employment, in which the value of expression is weighed against the needs of the employer. However, the doctrine of employment at will precludes any legal protection for at-will employees who are dismissed or disciplined for expressing their view, no matter the subject, location, or audience.

### 8.3.3: Arguments over Expression

The arguments against a right for workplace expression are, for the most part, the same as the arguments for employment at will. Private corporations are the property of the owners, who have a right to use their property, make contracts, and generally run their businesses as they see fit. In addition to a right to earn profits by operating efficiently, corporations have legitimate interests in building and maintaining a loyal, committed workforce, preserving the confidentiality of information, and protecting their reputations.<sup>33</sup> Although these rights and interests would generally lead corporations to respect employees’ views and, in most cases, not seek to suppress them, some expressions can create discord in the workplace, undermine loyalty and commitment, release confidential information, or tarnish a corporation’s reputation.

The arguments for a right to freedom of expression in the workplace generally parallel those for the corresponding right for citizens in a state, which underlie the First Amendment guarantee of free speech. These arguments divide into two groups, depending on whether freedom of expression benefits individuals or society.

1. *Benefit to Individuals.* Individualist justifications, which are similar to arguments for a right to privacy, emphasize the importance of free speech for our development as persons. The freedom to express ourselves is an essential component of individual autonomy and liberty, and it contributes to a sense of worth and dignity.<sup>34</sup> Although these benefits can be gained by expressing ourselves outside of the workplace, the long hours that employees spend at work reduce the opportunities for free expression, and the workplace itself may counteract some of these benefits by, for example, limiting our autonomy or dignity.
2. *Benefit to Society.* The social arguments for freedom of speech or expression generally cite its importance for the search for truth and the operation of a free, democratic society. John Stuart Mill’s famous *Essay on Liberty* justifies freedom of speech on the grounds

that the competition of truth and falsehood in a marketplace of ideas is the surest method for allowing truth to emerge and become stronger in the process. Although a marketplace of ideas can operate outside the workplace, the efforts by the business community to advance its ideas and beliefs cannot be effectively countered if voices inside corporations are silenced. Bruce Barry contends, “Where suppression of one’s power to think, speak, and dissent is conventionally accepted in workplaces, the ideology of management is given license to run free, not just at work, but everywhere.”<sup>35</sup> Furthermore, a modern democratic society requires that people with disparate interests and desires find ways of cooperating and living together harmoniously. This cooperation and harmony are possible only if people can express their interests and desires freely as part of a democratic decision-making process.<sup>36</sup> Because so much of people’s interaction with others and the development of sociability occur in the workplace, a democratic society cannot function if free expression is limited to the time spent away from work. Cynthia L. Estlund observes, “The sheer amount of sociability and cooperation that takes place every day in workplaces should place them at the center of any account of what holds a complex, modern democratic society together.”<sup>37</sup>

Although these arguments for a right to expression in the workplace have merit, they must be weighed against the legitimate rights and interests of employers. Some acts of expression in the workforce, such as derogatory insults, disruptive criticism, and disclosure of confidential information, are, arguably, just grounds for dismissal or discipline. Crafting legal remedies that strike the right balance is difficult. The main options of extending the First Amendment right to free speech to the private sector and making an additional public-policy exception to employment at will might unduly restrict private employers. The other alternative is for employers to respect employees and allow, even encourage, responsible expression in the workplace.

### WRITING PROMPT

#### Self-Censorship at Work

Consider some of the things you have wanted to say or talk about at work, but didn’t. What stopped you? Short of confidential information, is there any topic or opinion that you can imagine being justifiably fired or disciplined for voicing? Give an example or explain whether you think there should be limits to speech at work.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 8.4: Workplace Democracy

### 8.4 Analyze the correlation between worker participation and workplace democracy and how Dahl’s argument supports workplace democracy as a right

The typical workplace is organized as a top-down hierarchy, in which most employees merely follow orders from above. Many workers participate in decision making within a limited sphere of responsibility, but business organizations are not democracies in which everyone has a voice in the decisions that most affect them. Corporations bear a greater resemblance to military organizations, which exhibit a rigid chain of command and an unquestioning acceptance of authority. However, a central tenet of the theory of democracy is that the exercise of state power by a government is legitimate only if the citizens subject to this power have a right to participate in decision making, including the democratic election of leaders. Otherwise, the government is an illegitimate dictatorship. So, are corporations more like an army or a political state? And can the exercise of power by corporate leaders be legitimate if there is no participation in decision making by employees?

The ideas of participation in decision making and workplace democracy have been the subject of limited experimentation with slight success. Some forms of employee voice that appear to enhance productivity have been widely adopted, and most employees have some say about their work. If the efficiency gains of employee voice were greater, then more of it would have already been adopted by businesses. The implication is that additional participation and democracy could not be achieved without some loss of productivity. However, if the moral arguments are sufficiently compelling, then more participation and democracy would be worth the price. Countries in Western Europe that have mandated works councils, code-termination, and other means of worker involvement in decision making apparently believe that the moral benefits outweigh the economic costs. In the end, perhaps the extent to which employees have a right to participation and democracy in the workplace is a decision to be made in the political sphere through legislation rather than through voluntary action by businesses.

### 8.4.1: Participation and Democracy

The terms “worker participation” and “workplace democracy,” which are often used interchangeably, cover a variety of arrangements.

**Worker participation** may be defined as “a process that allows employees to exercise some influence over their work and the conditions under which they work.”<sup>38</sup> Sample forms of participation include works councils, which are shop-floor worker organizations that are mandated in

many Western European countries; codetermination, in which workers elect one or more board directors to represent them; grievance, mediation, and arbitration proceedings, which may be stipulated in employee contracts; collective bargaining by unions; quality circles and other employee involvement in total quality management programs; and self-directed teams.

**Workplace democracy** includes participation but also involves more substantial control. According to one definition, “Workplace democracy exists when employees have some real control over organizational goal-setting and strategic planning, and can thus ensure that their own goals and objectives, rather than only those of the organization, can be met.”<sup>39</sup> There are few examples of workplace democracy outside of employee-owned firms or worker cooperatives, which are not uncommon.<sup>40</sup> In general, the implementation of participation and democracy is much more extensive in Europe and Japan than in the United States.<sup>41</sup>

## 8.4.2: Arguments for Democracy

Although participation and democracy in the workplace have been proposed and implemented for reasons of increased organizational effectiveness and productivity,<sup>42</sup> the concern here is with moral arguments. Some advocates cite the same benefits as freedom of expression, such as the promotion of autonomy, dignity, personal development, and even physical and mental health.<sup>43</sup> However, the main moral or ethical arguments, especially for workplace democracy, involve the contribution that it makes to political democracy and, further, the need for democracy in order to legitimize power or authority in economic organizations.

1. *Contribution to Political Democracy.* The first argument for workplace democracy holds that in the workplace, where people spend a great portion of their adult life, people develop the attitudes, interests, and skills of citizenship that are critical for being an active citizen.<sup>44</sup> Consequently, if people do not participate in workplace decisions, they may lack the ability to engage in outside political activity. Thus, Richard Sobel observes,

Perhaps those empowered by activities within the workplace pursue analogous political involvement outside because they learn to be political on the job. Those who do not participate in work decisions . . . do not learn skills that carry over to the political sphere: avoiding office or shop politics may lead to avoiding politics outside, while being political at work encourages being political in the community. The quality of political life may, then, depend on the quality of work life.<sup>45</sup>

Although workplace participation is likely to have some impact on civic involvement, the evidence of any significant effect is weak.<sup>46</sup>

2. *Need to Legitimize Authority.* The second argument, the need for legitimacy, is theoretical rather than empirical. That is, it is based on considerations of democratic theory rather than factual evidence about the impact of workplace democracy. Although theoretical arguments have been developed in many forms,<sup>47</sup> the best-known version is that presented by the noted political theorist Robert A. Dahl. In *A Preface to Economic Democracy*, Dahl develops an argument with three premises:

1. the state is only one kind of association,
2. the argument for democracy in a state can be generalized for any association, and
3. an economic organization is an association to which the argument for democracy applies.

Hence, it follows, in Dahl’s words, that “if democracy is justified in governing the state, then it must *also* be justified in governing economic enterprises.”<sup>48</sup>

### WRITING PROMPT

#### A Spectrum of Participation

Which is easier to imagine: a company that operates as a direct (or “pure”) democracy, where all employees have a say and can directly influence major decisions, or one where employees are simply consulted on major decisions? Explain your view.



The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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**EVALUATING DAHL’S ARGUMENT** The first question to be asked about Dahl’s argument is this:

What is the argument for democracy in an *association*? That is, what is it about an association that requires democracy?

Any association is composed of persons with different and, sometimes, incompatible interests who join together in order to further their own interests. However, associations must make some rules that are binding on all members and may affect their interests differently. Because these rules affect people’s interests, they should be made by those who are bound by them. If the members of an association are equal in their claims that their interests be satisfied, then they should have an equal vote in all decisions about mutually binding rules. According to this argument, members of an association have a right to a democratic vote as compensation for forgoing their interests, in some instances, for the benefit of others. Dahl’s argument is thus based on distributive justice: The right to democratic rule making ensures a just distribution of benefits and burdens in a cooperative endeavor.

This argument supports democracy in a state, but does it apply to business organizations? Dahl addresses this second question by attempting to refute claims that corporations are different from states. Specifically, there are two possible objections:

1. that members of corporations are not bound by rules, and
2. these members do not have equal claims.

First, unlike citizens of a state, who are compelled by force to obey laws, members of a firm join voluntarily and are free to leave. The sanction for a citizen who violates a law may be imprisonment, but the worst a company can do to a disobedient employee is dismissal. Second, the members of a corporation are not equal, either in their decision-making abilities or in their claims on the firm. Corporations are not associations within which we live our lives, as is the state, but special-purpose entities created for economic production. Engaging in production requires considerable knowledge and many specialized skills that are possessed by only a few, so that most decisions in business cannot be made effectively by everyone in an organization.

Moreover, the goal of a corporation is not a good life for its members, as in a state, but efficient economic production. In the productive process, people bring different resources that form the basis of their claims. These resources are the private property of the different parties, and these parties exercise their property rights by making economic transactions. The claims that people have on a corporation are principally for the economic return on the resources provided. Employees' claims are, in part, for wages, though other groups such as shareholders, suppliers, and customers also have claims. Specifically, the basis for control of corporations by shareholders and management acting for their benefit is property rights: Shareholders are the owners of a corporation and, as such, have a right to operate it in their own interest.

### How can Dahl argue that members of corporations are like citizens?

#### Dahl's Responses to Objections

To the objection that employees of a corporation are not bound by rules, Dahl replies that the sanctions for violating a rule need not be as severe as imprisonment by the state.<sup>49</sup> Losing one's job for disobedience is sufficiently severe to qualify as an exercise of coercive power by a business organization. Such coercive power is not justified unless the rule violated was adopted by a democratic process.

As to whether employees are equal in their ability to make decisions, Dahl argues that employees, like citizens, do not have the competence to make every decision, but they have enough interest in the success of the firm to

delegate decision-making power about matters outside their competence to others.<sup>50</sup> Moreover, Dahl cites the experience of employee-owned firms, which manage to make rational economic decisions.<sup>51</sup>

The most difficult problem in Dahl's argument is the claim that employees in a corporation have equal claims.

- First, the argument overlooks the point that many groups, including shareholders, customers, and suppliers, have claims on a corporation. A business organization as an association does not consist solely of employees; it encompasses all groups who contribute to production.
- Second, workplace democracy seems to violate property rights, especially the rights of the shareholder-owners of a firm.<sup>52</sup> In an employee-owned firm, the employees, in effect, buy the company, which gives them the right to make decisions. But what if the firm is not owned by the employees?

Why should employees of a firm owned by others have a right to operate it as if they owned it?

Dahl's response to this objection is to deny that the right to property is a moral right at all.<sup>53</sup> Property rights, as they exist, are themselves allotments made through a democratic process. They are merely conventional rights, and as such they are subordinate to the moral right of workplace democracy and must give way when there is a conflict. In the words of one commentator, "In economic associations it is democracy that is trumps, not the ownership of assets, because power over people is morally non-negotiable."<sup>54</sup> However, given that the right to property is an essential element of capitalism, it may be questioned whether Dahl's argument for workplace democracy is compatible with a capitalist economic system.

## 8.5: Worker Compensation

### 8.5 Assess the market forces and other factors that influence employee compensation, the fairness of wages, and justifications for a minimum wage

Compensation or pay is one of the most important aspects of employment. The level of compensation influences people in their selection of an occupation and in their decision to accept a particular job. On the job, employees are motivated by pay and are intensely concerned with whether their pay is just or fair.

Asking whether compensation is just or fair invites the further question: Compared to what? Most employees are concerned about how their pay compares with others in the organization and elsewhere who hold similar or comparable jobs. This kind of comparative justice may be determined by a comparison of jobs and pay scales. However, on

this conception of fairness, all workers could be underpaid or overpaid, but the pay would be perceived as fair as long as there was a rough parity of similar jobs and differences in pay were proportional to the effort and ability required. Another kind of justice or fairness involves the factors that ought to determine the absolute level of pay for any job.

What factors are relevant in judging whether any given level of pay is just?

This question leads to many more specific ones, including whether it is unjust to pay wages below a certain minimum level.

### 8.5.1: Setting Wages

The compensation systems of large corporations are designed and operated by human resource professionals and compensation consultants in order to ensure that pay scales are both fair and efficient. In small companies the pay-setting process is often rather informal but follows the patterns set by larger firms. Determining the appropriate level of pay for each employee and the appropriate distribution of wages among all employees is vitally important for the success of any business. Although compensation is determined largely by market forces, employers must consider not only the market price of labor but also the effect of pay on attracting, retaining, and motivating their employees. In addition to the level of pay, employers must also consider the form in which employees are compensated. Besides wages, compensation takes other forms, including bonuses, profit sharing, employee stock ownership plans (ESOPs), fringe benefits (especially health insurance and pension plans), and employee stock options.

The level and the form of pay are determined mostly with a view to efficient production, which includes worker motivation and satisfaction, but they may also be linked to decisions about a company's strategy. For example, Walmart has pursued a strategy of low-priced products that depends on low wages and few benefits for a heavily part-time labor force. Meanwhile, Starbucks pays relatively high wages with generous benefits to its workers, as part of a strategy of providing a special ambience for customers. The higher compensation at Starbucks is offset by the benefits of a more skilled workforce with lower turnover and an experience for customers that enables the company to charge high prices for coffee. The differences in compensation at Walmart and Starbucks are due not merely to the cost of labor in the market but also to these companies' different strategies. However, the surprise announcement by Walmart in early 2015 of a substantial increase in hourly wages was interpreted by some observers as the company's strategic response to a changed competitive environment.<sup>55</sup>

Compensation is not only a matter of concern in production and strategy, but it is also a moral issue.

- First, the attitudes of employees, who depend on a paycheck for their livelihood, are affected by perceptions of fairness in the pay-setting process and in the overall distribution of pay in an organization. Even well-paid employees may be resentful if they perceive some unfairness.
- Second, society, which is concerned with people's welfare, has a strong interest in the justice of compensation. Among the conditions for a just society are that people's basic needs be met and that income and wealth be distributed justly. If the income that people receive from working enables them to meet their basic needs, then compensation helps to create a just society. However, if some people cannot support themselves from their earnings in a job or have no job at all, then an unjust society may result, and it may fall to society to provide for their well-being and secure justice.

Defenders of a market distribution of income and wealth argue that people deserve whatever they can gain in a market, and that the existence of poverty or inequality of income and wealth is not in itself unjust. If a market distributes income and wealth in ways that society considers to be unjust, any injustice can be corrected in one of two ways. One is to place legal limits on the operation of the market by, for example, minimum wage laws that mandate a certain level of pay. The other way is to provide for basic needs and to redistribute wealth through government programs, such as the welfare system and progressive taxation. If the latter course is taken, then the justice of compensation need not be a concern for companies, as long as the state corrects for any injustice that occurs in compensation. It is an open question, therefore, whether justice in compensation is a task for private employers or government—or perhaps both.

In a free-market economy, the compensation of employees is determined largely by market forces. Any discussion of justice in compensation must include, therefore, an understanding of how pay is set in a market and an assessment of whether the pay so set is just.

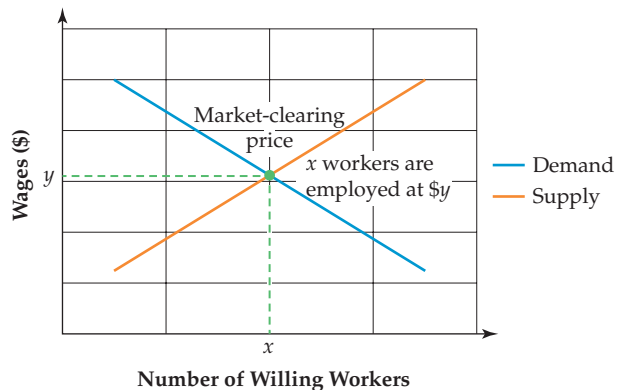
### 8.5.2: Market Outcomes

Economists view the level of wages as a reflection of the market price for labor. On this economic view, labor is simply one input into the productive process, and just as raw materials and equipment have a market price, so too does labor. In general, the price of an input or good is a function of supply and demand. Supply and demand are in equilibrium when at any given price, the supply of a good equals the demand for it, so that all of that good sells and no demand goes unsatisfied. If, at any given price, demand exceeds supply, buyers offer to pay more for a good and hence raise the price. Similarly, if the demand drops, then sellers will be forced to reduce the price until a sufficient

number of buyers are found. In the case of employment, a shortage of workers will lead employers to raise the wages offered until enough workers accept a job, and a surplus of workers will result in a drop in wages until only the desired number remains.

**EFFICIENT MARKETS** The wage at which exactly the desired number of workers is employed is called the *market-clearing price* (see Figure 8.3).

**Figure 8.3** Supply and Demand in an Efficient Employment Market



In an efficient market, all workers employed will receive at least the market-clearing price for the reason that if an employer offers wages below it, a sufficient number of workers cannot be induced to take a job with that employer (because better-paying jobs are available elsewhere), and the employer will lose an opportunity to employ the desired number of workers productively. However, if wages are above the clearing price, employers will have an opportunity to cut the cost of labor and still have the desired number of workers. Any employer who does not take advantage of such a cost-cutting opportunity will be at a competitive disadvantage to competitors who do.

Another way to put the economist's account is that in an efficient market, wages will equal the *marginal product* of a worker's labor. Each incremental increase of any input in production will, up to a certain point, increase the value of the output. That is, if a product is in demand, hiring additional workers and buying more raw materials and equipment will yield more sales and hence more profit. The marginal product is the value that each incremental increase of an input adds in the production of any good. Employers will seek to add inputs as long as the marginal product exceeds the cost of the input. For example, if each worker hired by an employer leads to an additional revenue of \$1 for each unit produced, then the employer will keep adding workers and attracting them, if necessary, with higher wages up to \$1 for the time needed to produce that unit. Wages will continue to rise until workers receive

the full value of what they add to the productive process, which is to say the marginal product.

**JUSTICE OF MARKETS** Assuming that workers received the full value of their marginal product (which is not always the case), it can still be asked:

Are the wages set by market forces just?

The economist's answer is that market transactions result from voluntary contracting, in which every party willingly consents to an exchange. Thus, workers are free to work on their own or otherwise seek the most lucrative employment. A plumber, for example, can work as an independent contractor, offering his or her services to whomever is willing to pay. A plumber who is able to make more income working for an employer is merely putting his or her productive potential to its most valued use. Thus, workers seek to sell their labor at the highest price they can—whether they work for themselves or others—and whatever price they can get is fair because it represents the best bargain that can be struck between economic actors.

Furthermore, all input providers receive as a return some portion of the revenues of a business firm. The input providers collectively cannot receive more than a firm earns from engaging in productive activity. Consequently, if one group receives more than the market value of its input, then some other group must receive less. Thus, if employees are paid more than the market-clearing rate or marginal product, then some other group receives less than the market price of its input. For example, customers may end up paying more for products than they would otherwise. Since workers are also consumers, what they receive in higher-than-market wages, they may have to spend buying higher-than-market products.

In addition, the price system is critical in ensuring that the economy operates efficiently so that resources are used most efficiently and the greatest amount of total wealth is created. If any input, including labor, is not accurately priced, then the whole economy suffers. One possible consequence of distorted prices is that employers might not create jobs that would otherwise be created in an efficient economy. Consequently, any gain to employees from higher-than-market wages might be lost in fewer available jobs and a less prosperous economy overall.

Finally, the wages set in a free-market economy reward people in proportion to the knowledge and skills that they have acquired and the effort expended. Workers make an investment in the factors that make them productive—what economists call *human capital*. It is only fair that those who have made a greater contribution to productivity receive a proportionately greater return. Conversely, it would be unfair to pay everyone the same without regard for their contribution. In summary, the arguments for justifying wage-setting by a market rest on the ethical principles of *freedom* (in market exchange), *welfare* (the greater



wealth produced), and *desert* (receiving in proportion to one's contribution).

**CHALLENGES TO MARKET JUSTICE** These arguments may be challenged.

**First**, if there were a large number of potential workers in jobs that require few skills, the market-clearing rate would be so low that employers could exploit the opportunity to offer unconscionably low wages. This possibility was identified by Karl Marx as the "reserve army of labor," which he thought would drive down wages in a capitalist economy to poverty levels. Although such a situation prevails in some developing countries, it is not the case in developed economies, and the best remedy for a mass of unemployed workers is raising the productivity of workers so that they can command higher wages.

**Second**, the bargaining that takes place in labor markets may be among parties with unequal economic power, so that workers do not receive the true market value of their labor. This objection may be used to support labor unions as a necessary counterweight to the power of employers. Political power may also hamper workers in bargaining effectively when companies influence the government to obtain favorable laws and regulations.

**Third**, the wealth created by a firm may not be distributed equitably in proportion to each group's contribution. That is, the market may be skewed in favor of one group over another. Among the causes of such inequitable distribution are well-recognized instances of market failures.

**Examples:**

- The bias in a market economy for private over public goods helps to explain why investment bankers are paid much more than school teachers, despite the similar contribution of their services to society.
- Market economies also produce "winner-take-all" competitions in which a few "superstars" in any industry (e.g., sports and entertainment) are able to gain outsized rewards.<sup>56</sup>

**Finally**, capitalist economies produce significant degrees of inequality in the distribution of income and wealth that may undermine social welfare and stability. Thus, even if economic exchanges are purely voluntary and enhance the overall welfare of a society, low- and middle-income workers who do not benefit from increasing wealth creation in society might rightly claim that benefits of the economy are not being justly distributed. This consequence is one reason for a legally mandated minimum wage.

### 8.5.3: Minimum Wage

A minimum wage is the lowest wage that an employer may legally pay to employees. Minimum wage laws have

been enacted in virtually all developed and most developing countries. Related to the minimum wage is the call for a "living wage," which is commonly defined as a wage for a full-time worker that would enable that person to attain a standard of living that is above the poverty level or some other measure of well-being.<sup>57</sup> In the United States, organized support for a living wage law has focused predominantly on municipalities. By 2014, at least 140 cities in the United States had adopted a living wage ordinance, with legislation pending in several large metropolitan areas.<sup>58</sup> A living wage is invariably higher than a legal minimum wage, though the arguments for and against the two concepts are generally the same.

**JUSTIFYING A MINIMUM WAGE** Two rationales have been offered for minimum wage legislation.

1. *Exploitation.* Some proponents contend that it is exploitative for employers to offer unconscionably low wages to workers who have fewer employment options. Richard T. DeGeorge writes, "A just legal and political system must at least provide an income floor and must keep desperation out of the market by providing alternatives to forced acceptance of any wage offered, regardless of conditions."<sup>59</sup> On this view, the absence of a minimum wage permits an impermissible kind of coercion that violates people's dignity and autonomy. Such a state of affairs is morally wrong and presumably should not be permitted regardless of the economic consequences.
2. *Redistribution.* A second, and more common, rationale for a minimum wage is that it serves to redistribute income in society so that the lives of workers at the lowest income levels are improved. Although a redistribution of income may be sought for many reasons, including a compassion for the poor and social and political stability, an important reason, no doubt, is a sense that a just society should provide for everyone's basic needs. If this is a moral obligation, then the redistribution argument for a minimum wage is founded on morality, as is the exploitation argument.

There are two important differences between these two rationales, however.

- First, if the absence of a minimum wage permits exploitation, then a law should be adopted regardless of the economic consequences. However, if a minimum wage is intended to redistribute income, then it matters whether it, in fact, achieves this goal, and there is no reason to have a minimum wage if it fails to do so.
- Second, there are many means besides a minimum wage for redistributing income, and so there is no moral imperative to have a minimum wage if other means of distribution work as well or better. If exploitation

would occur in the absence of a minimum wage, though, then it is morally imperative to have one.

The exploitation argument is questionable.

- First, the experience in developed countries is that workers without skills are not coerced into accepting jobs at extremely low wages. Jobs in the informal, unregulated economy, such as illegal clothing factories, and in agriculture, which is not covered by the minimum wage law, typically pay very low wages, and the people who take these jobs have few other opportunities and work under uncomfortable conditions. However, they choose these jobs in preference to the alternatives, and so it is not evident that their dignity or autonomy is denied.
- Second, if no higher-paying jobs are available (and a worker would surely take one if it were), then it is difficult to see how a minimum wage that would deny them any job at all improves their situation. Indeed, that denial might be a violation of their dignity and autonomy.

**QUESTIONS ABOUT JUSTIFICATION** If the purpose of a minimum wage is redistribution, then there is the moral question of whether income ought to be distributed for the benefit of low-income workers, and the empirical questions of whether a minimum wage has that effect or is the most effective means. Although the moral question is debatable, some amount of redistribution has been an accepted goal in all industrialized countries for more than a century, especially in view of the great increase in inequality that has accompanied modern industrialization. This question is moot, however, in the debate over the minimum wage if legally prescribed minimum wages do not have a redistributive effect. Economists generally argue that a minimum wage does not redistribute income to low-wage earners and, in fact, harms them by reducing the number of jobs. However, the empirical evidence for this position is inconclusive.

Economists commonly argue that employers create jobs only when the marginal product of new workers—which is to say, the value that a new worker adds to production—is equal to or less than a new worker’s wage.<sup>60</sup> Any employer who hires a new worker at more than that worker’s marginal product will lose money unless the cost can be passed on to others. Consequently, there are new jobs that would be created at a lower wage that will not be created if an employer is required by law to pay a higher wage. If the cost is passed on, the result will be some combination of lower wages for higher-earning workers, higher prices to consumers for products, and lower profits for investors. In addition, a minimum wage may attract more teenagers, many from affluent families,

into low-paying jobs, which will reduce the number of jobs available to adults without skills. Some of these consequences may result in a redistribution downward, but low-wage workers and especially the unemployed are likely to bear the brunt of the losses. To the extent that prices are distorted, decisions by businesses, consumers, investors, and workers themselves may not result in the greatest possible wealth creation. For example, a minimum wage may reduce the incentive for low-wage workers to improve their job skills and seek higher-paying jobs.

The empirical evidence for the economist’s theoretical argument is inconclusive.<sup>61</sup> In a much-discussed study, David Card and Alan B. Krueger examined the effect on employment in the fast-food industry after a rise in the New Jersey minimum wage in 1992 compared with nearby Pennsylvania, which did not change the law.<sup>62</sup> Card and Krueger found no significant difference and detected even a slight rise in employment in New Jersey after the change in the minimum wage. Another study found that a rise in the minimum wage can have a slight distributional effect, especially if it is linked with other policies and programs to help the poor.<sup>63</sup> These conclusions have been challenged.<sup>64</sup> Virtually all economists agree, though, that whatever the distributional effect, which is small at best, the minimum wage is a very inefficient way to raise the income of the poor.<sup>65</sup> Other means can do this more effectively with less harm to the economy.

### WRITING PROMPT

#### Reasons for and against a Minimum Wage

Where do you stand on the need to increase the minimum wage? Is your position based simply on the economic effects of the minimum wage, or is the minimum wage needed for a just society, whatever its economic impact?



The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 8.6: Executive Compensation

### 8.6 Evaluate the reasoning underlying criticisms and justifications of the compensation for top executives

Few business practices have drawn as much moral criticism as the compensation lavished on the top executives of large corporations and especially on the chief executive officer (CEO). Although the rapid rise in CEO pay occurred between 1995 and 2000, the criticism began around 1990

when many companies were shedding jobs and workers' wages were stagnant. Executive compensation declined during the financial crisis of 2007–2008, but it rose again with the economy's recovery. Between 2010 and 2012 average CEO compensation rose 18 percent once salary, bonuses, and the appreciation of stock holdings are considered.<sup>66</sup> Median CEO compensation continued to rise 9 percent in 2013.<sup>67</sup> During this recovery, much attention focused on the disproportionate gains for the top 1 percent and the loss of ground for most workers. The increasing inequality of income and wealth in developed countries has become a potent political issue. The combination of increasing wealth for CEOs, declining worker fortunes, and stark inequality has struck many people as unfair.

### 8.6.1: Criticism of CEO Pay

Aside from the huge CEO pay packages, which have exceeded \$400 million for a few recipients, critics have noted that some of the companies awarding high executive compensation performed poorly, so that pay seemed to be unrelated to performance. In some cases, CEOs received handsome rewards upon departure from a company, after their value to the company had ended. Another concern is the lack of proportion between executive compensation and the pay of lower-level employees. The top CEOs make 400 to 500 times the income of the average worker. In addition, CEO pay has grown much faster than the average paycheck.

One justification for high executive compensation is its incentive effect to induce CEOs to perform at their best. Some critics argue, though, that the same effect could be achieved at lower cost. As Derek Bok, a former president of Harvard University observes, "But there is no reason to suppose that American executives would work less hard if they were paid several hundred thousand dollars a year instead of several million."<sup>68</sup> Critics also note that CEOs in Europe and Japan are paid much less but still seem to be effective. Moreover, too much compensation might have unintended consequences. CEOs who are intent on raising stock price, upon which most incentives are based, may pursue short-term strategies that harm the company in the long run or pursue excessively risky, bet-the-farm strategies in hopes of a high payoff. Strong monetary incentives may also lead to questionable accounting practices and even fraud.

### 8.6.2: Justifying CEO Pay

The total compensation of a CEO is set by the compensation committee of the board of directors, which is acting on behalf of the shareholders. Directors have a fiduciary duty to make all decisions, including those about CEO pay, in the best interests of the shareholders. The value of

a CEO to the corporation and its shareholders is determined, in part, by a market for CEOs that operates like any labor market on the basis of supply and demand. One factor in the amount of pay offered by a board to a CEO is the value that that person can bring to a firm, which is to say, his or her *marginal product*. The decisions that CEOs make have profound consequences for a company and the whole of society. If the difference in performance of the very best CEO and the second-best choice is, for example, \$100 million in profit, then it benefits the shareholders to pay up to that amount to get the best person available.

In addition to the marginal product of a CEO, the board must consider two other factors.

- One is that the CEO must be motivated to achieve the maximal results. However, unlike most workers, who need to be motivated only to accomplish specific tasks, a CEO must conceive and implement the best strategy for a company. This is best done by tying CEO pay to some measure of corporate success, such as stock price. Thus, bonuses, stock grants, and stock options, which are responsible for much of the recent increase in CEO pay, are a distinctively effective way of motivating a CEO, as well as measuring success.
- Second, in addition to motivating a CEO, compensation must be designed to overcome an agency problem. The interests of CEOs may not be the same as those of shareholders, and so a chief executive must be induced to become a loyal agent of the shareholder principals. One function of CEO pay in stock and stock options is to align the interests of a CEO with those of the shareholders by making that person a special kind of shareholder. Put simply, in setting CEO pay, the board of directors is "buying" not merely a CEO's services but also that person's loyalty.

The standard justification for CEO compensation is that it represents a bargain struck between a CEO and the board over the value of a CEO to a corporation and its shareholders. When a CEO is hired, it is difficult to determine what value the CEO will bring to a firm. However, both the CEO and the board make their best estimates. One reason for compensating CEOs with bonuses and stock options is that the pay becomes contingent on performance. A poorly performing CEO may get little, while a successful one is richly rewarded. Thus, whatever amount is agreed to in arm's-length negotiation between the two parties is just, no matter the amount. Even though some CEOs produce disappointing results, they deserve the amount offered because of the initial agreement in which both sides made a good faith attempt to predict the CEO's value to the firm. And CEOs who produce superlative results deserve what they receive because much of their pay has been tied to performance.

Still, are some CEOs worth tens or even hundreds of millions of dollars? Warren Buffett has been quoted as saying, “You’ll never pay a really top-notch executive . . . as much as they are worth. A million, \$3 million, or \$10 million, it’s still peanuts.”<sup>69</sup> However, Graef Crystal, a persistent critic of executive compensation, questions the linkage between pay and performance.<sup>70</sup> Although sports and entertainment figures negotiate multimillion-dollar contracts, Crystal finds that at least 70 percent of those amounts can be explained by the extra revenue these stars generate. Crystal’s studies have never been able to account for more than 40 percent of CEO pay by such factors as company size, performance, business risk, or industry type. Crystal concludes that the pay of top executives is highly arbitrary, with some CEOs receiving two to three times what his model indicates as “rational.”

Other evidence indicates that much of the high pay in recent years has been due to strong performance in a robust economy. Michael Jensen and Kevin Murphy found that CEOs typically receive about \$3.25 for each \$1,000 increase in shareholder wealth.<sup>71</sup> At this rate, the amount of wealth created by American corporations since 1990 would result in very high compensation. In addition, two other researchers, Xavier Gabaix and Augustin Landier, calculated that the sixfold increase in executive compensation in S&P 500 corporations between 1983 and 2003 was accompanied by a corresponding sixfold increase in the market capitalization of these firms.<sup>72</sup> These figures suggest that the increase in compensation was proportional to the wealth that was created.

## WRITING PROMPT

### The Market for CEOs

A commonly cited statistic in the controversy over executive compensation is the ratio of a CEO’s annual earnings to the average or median salary of a “rank-and-file” employee. For instance, a CEO may make hundreds of times more each year than the average worker. How can this discrepancy be justified? How do CEO compensation packages differ in principle from the performance incentives and bonuses offered in other positions, such as commissions for salespeople, a percentage of box office receipts for movie stars, or even tips for servers?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

### 8.6.3: Problems with Justification

One objection to the standards justification of CEO compensation is that its core assumption—that the agreement results from arm’s-length negotiation between a CEO and the board, acting for shareholders—is not entirely true.

Lucien Bebchuk and Jesse Fried in their book *Pay without Performance* argue that CEOs have undue influence over the process with the result that boards are unable or unwilling to engage in tough negotiations.<sup>73</sup> They contend that CEOs have power over the selection of directors, who are consequently beholden to the CEO. Board members are also linked to the CEO and each other by social ties, and they are often CEOs themselves, with a vested interest in high compensation. Even board members who might be inclined to bargain aggressively typically lack the skill, time, and information to do so. Boards are often advised by compensation consultants who serve the company as well, and so have little incentive to alienate the CEO.

The Bebchuk and Fried thesis has many skeptics.<sup>74</sup>

- First, the thesis would apply only to incumbent CEOs, but incoming chiefs, who have had no opportunity to influence the board, receive similar pay packages.
- Second, high compensation also occurs in privately held companies where shareholders have greater control.
- Third, some boards are more independent of the CEO than others, but there is no evidence that pay varies with the degree of board independence.
- Finally, it may be better for boards not to negotiate aggressively with a CEO with whom the board must work closely. Thus, it may be in the shareholders’ interest that CEOs be paid generously in order to avoid strife.

In sum, although CEOs undoubtedly have some power over the setting of their own pay, it is not clear that their influence has produced the current high level of executive compensation.

Another group of critics objects that even if CEO compensation results from arm’s-length bargaining with the board, and even if selecting and motivating a CEO who will create maximal wealth for shareholders and thereby benefit society, the inequality of income and wealth that high compensation produces is morally objectionable. Just as low compensation below a minimum or a living wage creates social problems, so, too, does very high compensation. The problems resulting from great inequality in wealth and income include less social cohesion and increased strife and resentment both in business organizations and among members of society. Critics who object in this way generally hold that justice requires a certain distribution of income and wealth that differs from that produced by markets. One reason for the comparatively higher pay of executives in the United States, with its emphasis on individualism and freedom, may be that in Europe and Japan there is less acceptance of market outcomes and more concern for the common good.

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## Conclusion: Employment Rights

Employee rights are important because so much of people's lives is spent at work, and injustice on the job seriously impacts people's lives. Justice is also a great concern to employers because workers are very sensitive to perceptions of unfair or unjust treatment and act accordingly. Employers violate employee's rights at their peril. However, the extent of employee rights is uncertain. Some rights, such as the alleged rights to expression, participation, and a living wage, are arguably "manifesto rights," which is to say ideals perhaps worth striving toward. Other rights, especially due process in termination, have more solid moral grounding. A key question about employee rights, though, is the extent to which they should be enforced by law. There is a considerable body of labor law that ensures fair or just treatment of workers, but on many matters, such as termination, it is questionable whether justice should be legally mandated or be achieved by more informal processes in the workplace.

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### End-of-Chapter Case Studies

This chapter concludes with three case studies.

A few highly publicized instances of employees being fired for blogging—both about the job and solely about personal matters—have focused renewed attention on the ethically permissible grounds for termination. Employer-imposed restrictions on blogging are especially ironic at a company such as Google, which has been so instrumental in developing a blogging culture ("Fired for Blogging at Google"). The idea of worker participation in workplace decision making has waxed and waned over time, and the experience at Saturn ("Worker Participation at Saturn") provides an opportunity to consider whether meaningful worker participation is possible or even desirable. Fringe benefits, such as health insurance, raise ethical issues both about whether employers have any moral obligation to provide them and, if they are provided, whether they have been offered in a fair or just manner. "Health Benefits at Walmart" examines how these issues were addressed at America's largest employer.

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### Case: Fired for Blogging at Google

After 11 days in a new job at Google, Mark Jen was fired.<sup>75</sup> No reason was given by his managers, but Mr. Jen suspected that the abrupt termination was due to the blog he

was writing about his experiences as a recent hire at the company. His first job after graduating from the University of Michigan with a degree in computer engineering was at Microsoft, but he left 18 months later for greater challenge at the Internet giant. At Google, where he started on January 17, 2005, he was assigned to the AdSense division, which provided targeted ads to websites. His personal blog, "ninety-ninezeros" on blogspot.com, was intended to communicate with family and friends. The posts were mostly observations about what it was like to work at Google, especially in comparison with Microsoft.

With the fervid public interest in everything related to Google, other websites picked up the content, which brought unexpected attention to his blog. Suddenly, the number of hits soared, reaching a one-day high of 60,000, and Google managers took note. They first requested that he remove all posts, but after the site went dark, the reaction of puzzled readers concerned his managers, who subsequently asked him to repost the previous blog entries but with the deletion of sensitive information about Google products and the company's finances. He complied. Before continuing the blog, Mr. Jen inquired about a company policy on blogging but found that there was none. He examined the confidentiality agreement he signed upon taking the position and concluded that it did not prevent him from writing a blog. So he continued.

The posts contained mostly personal observations and bits of publicly available information. One comment was seemingly innocuous: "Both Google profits and revenue are growing at an unprecedented rate." On Friday, January 28, he was called into a manager's office and quickly terminated. No benefit package was offered, but he felt fortunate that he was not asked to sign a non-defamation agreement, which allowed him to write further about his experiences at Google. He could continue blogging on his own time, which was now plentiful.

Mark Jen's dismissal from Google sent shock waves through the blogosphere, causing many bloggers to fear for their own job security. Blogging about work, which is done by many employees, especially younger ones in tech companies, is subject to the nondisclosure agreements that are typical in the corporate world. Obviously, nothing confidential should be posted. Many companies maintain their own corporate blogs, some of which can be accessed only internally while others can be read by the public. The rules for these blogs are usually stated clearly and, in any event, activity can be easily monitored by managers. However, blogging that is done through noncorporate sites with

public access, like [blogspot.com](http://blogspot.com), not only defies easy company control but also belongs to the sphere of an employee's private life.

### What was the experience of other bloggers?

#### It varied by company

Getting fired for blogging, even away from work on one's own time, is not unknown. A Delta flight attendant, Ellen Simonetti, writing in her personal blog "Queen of Sky," was let go in October 2004 for posting suggestive pictures of herself in uniform on an empty airplane.<sup>76</sup> The word *dooced*, meaning to lose a job because of blogging, was coined after Heather Armstrong, hailed as "Queen of the Mommy Bloggers," was fired in 2002 for posts on her own website [dooce.com](http://dooce.com).<sup>77</sup> At Sun Microsystems, blogging was not merely permitted but actively encouraged by its CEO Jonathan Schwartz.<sup>78</sup> He blogged twice a week with his observations and urged his employees to blog as well. Blogging by employees, he said, moves them from the passive Information Age into the more active Participation Age, which "effectively enables participation in communities you wish to cultivate." He observed, "I can't think of a more appropriate way to interact with the marketplace than by encouraging the entirety of our employee base to do so."<sup>79</sup>

Bloggng offers many benefits for both employees and employers, as well as some hazards. Employees find that writing about life at work not only helps them keep a healthy balance between the personal and the professional but also builds workplace relationships by supplementing traditional water cooler interactions. Companies benefit from a more productive workforce as well as enhanced reputation with customers and communities. The hazards for companies arise not only from negative posts but also from the innocent release of damaging information. For example, Mark Jen's statement about the growth rate of Google's profits and revenue might have inadvertently run afoul of federal securities regulations on fair disclosure. A photograph posted by a dismissed Microsoft employee that revealed the layout of a company warehouse might have posed a security risk.

**Aside from the standard advice "Be smart," how should employees approach personal blogging? And what policy, if any, should a company adopt?**

#### Some Considerations

Mark Jen admits he made mistakes and feels little bitterness over his treatment by Google. Still, more guidance would protect employees and the company. Company policies commonly stress the need to state clearly that the views expressed are one's own and not necessarily those of the employer, but bloggers should also identify themselves as employees in any discussion of their own company.<sup>80</sup> Restrictions on the disclosure of confidential information, which are usually contained in employment contracts, apply not to

blogs alone but to all communications. A more controversial question is whether employers have a right to request that posts on personal blogs be deleted or altered, and whether employees have an obligation to comply.

The development of social media, including Facebook and Twitter, creates concerns for both employees and employers that extend far beyond personal blogging. A Twitter feed @GSElevator, which contained sardonic remarks purportedly overheard in the elevators at Goldman Sachs headquarters, quickly attracted more than 630,000 followers and spurred a search at the company for the mystery employee. The writer was eventually identified: He was a bond salesman who lived in Texas and had worked seven years at Citigroup. He had never been employed at Goldman Sachs, although he had once been offered a job there, writing. Despite the apparent misrepresentation, the writer was offered a reported "six-figure" advance on a contract that was subsequently withdrawn by the would-be publisher.<sup>81</sup>

### SHARED WRITING: FIRED FOR BLOGGING AT GOOGLE

If you were in Mark Jen's shoes, would you have complied with Google's requests to first unpublish and then edit your blog posts? Explain why or why not. Without providing clear, official guidelines for blogging and banned content, why would someone think that it was fair of Google to expect Jen to censor himself?

Review and comment on at least two classmates' responses.

▶ **A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.**

Post

0 characters | 140 minimum

## Case: Worker Participation at Saturn

A study undertaken by General Motors in 1982 concluded that the American automobile industry could not successfully challenge the Japanese in producing small, fuel-efficient cars without a radical overhaul of traditional manufacturing processes.<sup>82</sup> Out of this study came a proposal not just for a new automobile but for a new company, separate from GM's other units. The resulting Saturn Corporation, a wholly owned GM subsidiary, would utilize the advanced technology and management practices that had enabled the Japanese to gain a \$2,000 per car cost advantage over their American competitors. The Saturn factory would also make a radical break from the past by involving assembly workers in company decision making. The new

president of the Saturn Corporation declared, "Saturn is not a car, and it is not a manufacturing process. It is a new way of doing business with everyone."<sup>83</sup> Roger B. Smith, the chairman of GM, said, "The Saturn process is going to institute technology and business and management procedures so advanced that they don't exist anywhere in the world today, not even in Japan."<sup>84</sup>

Between 1983 and 1991, when the first car rolled off the assembly line, GM negotiated a revolutionary contract with the United Auto Workers union (UAW) that did away with conventional, hierarchical labor-management relations. The Saturn Philosophy set forth in the contract stated,

"We believe that all people want to be involved in decisions that affect them, care about their job and each other, take pride in themselves and in their contributions, and want to share in the success of their efforts."

In accord with the union agreement, Saturn workers, initially 6,000 in number, were organized into self-directed work units of 6 to 15 people with responsibility for a particular part of the production process. The work groups performed a series of operations taking several minutes and requiring some skill, instead of the quick repetition of a single task involving little skill on the typical assembly line. Among various other tasks, members determined job assignments, set work schedules, maintained equipment, and ordered supplies. In contrast to the dozens of job classifications used in traditional assembly-line production, there was one classification for production workers and three to five for skilled workers. Each team also elected one member to be a "counselor" to represent the union.

At the next level, three to six work units were formed into work modules, led by a company work unit adviser. Workers had union representation on all committees, including the Business Unit Committee that coordinated plant-level operations and the top-level Manufacturing Advisory Committee and Strategic Advisory Committee. Decisions at the plant were to be made by consensus to the extent possible. The agreement stated that any party may block a potential decision, but adds, "In the event an alternative solution is not found, the blocking party must reevaluate the position in the context of the philosophy and mission."<sup>85</sup> Although management reserved the right to make the final decision on any matter, employees still had considerable voice in the decision-making process.

In addition to participation in decision making, the Saturn contract provided for variable pay. There were no time clocks, and workers were paid a salary instead of an hourly wage. In the first year of operation, absenteeism at the plant was less than 1 percent, which is one-tenth of the rate at other GM plants and about the same as Japanese factories. The base pay for workers was set at 80 percent of the average compensation at other unionized GM factories, and the difference was to be made up by bonuses based on

productivity. Job security was provided by a guarantee that 80 percent of the workforce would be protected from layoff except in the case of "catastrophic events," and even then, layoff could be avoided by a consensus decision to substitute reduced work hours or temporary shutdowns.

### What eventually went wrong?

#### The problems began almost immediately

To produce the Saturn, GM built a state-of-the-art plant in Spring Hill, Tennessee, 25 miles south of Nashville. However, by the time the factory began operations, the American automobile industry was in a slump, and the demand for small cars was declining. The goal of producing 500,000 cars annually was cut in half, and because of production problems, the company did not make a profit the first year. During the 1980s, GM workers at any facility in the country could apply for a job at the Spring Hill plant, and many who moved were attracted by the prospect of worker participation. However, in 1990, applicants were restricted to workers who had been laid off at other GM plants. These workers were, on the whole, less enthusiastic about the new system and were more suspicious of management. Although the first workers were given 700 hours of training to prepare them for Saturn's cooperative work methods, the amount of training for subsequent hires was reduced to 175 hours.

By 1997, Saturn workers were becoming dissatisfied with the new system. The sales of the Saturn dropped almost 10 percent that year, and unsold cars were piling up at dealerships. Production was halted one day a week, and workers were put to other tasks around the plant. Workers' bonuses fell to \$2,200 in 1997 from \$10,000 in each of the two previous years. Workers blamed some of the problems on mistakes by management. GM had ignored workers' suggestions that Saturn produce small sport-utility vehicles. Although the Saturn was popular, the automobile itself was rather conventional in design, and GM had been slow to make improvements. In order to cut costs, GM was trying to reduce the number of frames and parts of its automobiles by designing Saturns with components from other GM lines made at plants with traditional labor contracts. The Saturn was intended to be a unique product, built entirely at the Spring Hill plant. However, the local union head complained, "They are just looking at basically outsourcing everything they can, and run it through a lean assembly and still call it a Saturn."<sup>86</sup> It appeared to workers that GM was trying to fold Saturn back into the parent company.

Despite their participation in decision making, some Saturn workers felt that they had lost the power of unionized workers in traditional plants. Historically, worker participation has been viewed as an effort by companies to reduce the power of unions. Even when well intentioned, worker participation programs are difficult to implement because they can be successful only if power is meaningfully

shared. Such programs have also been short-lived. According to one expert, “only 25 percent of all programs, meaningful or not, last beyond five years.”<sup>87</sup> Workers complained that their union leaders had become too close to management. In 1998, a proposal to abandon the Saturn agreement and replace it with the standard UAW labor contract was rejected by a margin of two to one, which means that a third of all workers supported the change. The next year, in 1999, the local union leaders who had guided the Saturn experiment from the beginning were voted out of office and replaced by new leadership that favored more traditional labor relations.

Although worker participation continued at Saturn until the end of production in 2009, the early dreams were not realized. Whether the failure occurred because of adverse economic conditions, company sabotage or the impracticality of worker participation remains to be determined.

### SHARED WRITING: WORKER PARTICIPATION AT SATURN

Some have said that Saturn would have been better able to respond to the changes in the automobile market if there had been more cooperation and greater compromise between the management, union leaders, and workers. What reason do we have to believe that this is true? Explain whether the failure of the company can be attributed to problems with Saturn’s original vision for worker participation, a lack of commitment to the ideals of workplace democracy at Saturn, or something else.

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Health Benefits at Walmart

Walmart, the world’s largest private employer with 1.3 million store workers or “associates,” has long been criticized for its low level of health benefits.<sup>88</sup>

### Conditions at Walmart

Walmart reported in 2005 that only 43 percent of its associates received company-sponsored health insurance. Approximately 27 percent of its workforce had not been employed long enough to be eligible for health benefits, although many would eventually qualify. Of the remaining 73 percent who were eligible, only 60 percent chose to enroll in Walmart’s health insurance plan. Some of those not enrolled had health insurance from a spouse or parent,

a previous job, the military, or some other source. Walmart estimated that in 2005, 75 percent of its associates had health insurance of some kind, but that the remaining 25 percent were completely uninsured.

The lack of health insurance extended to the children of Walmart associates. Among these dependents, 27 percent relied on government-funded health care (Medicaid and the State Children’s Health Insurance Program), and 19 percent of associates’ children had no health care benefits at all. Prior to 2006, only full-time associates could obtain coverage for children. In total, only 54 percent of the children of Walmart associates were enrolled in a Walmart health insurance plan. Medicaid was the principal source of health care payments for 4 percent of Walmart associates (compared with 5% of workers nationally). When adult workers and their children rely on government programs and hospital emergency rooms, the cost of health care is transferred from employers to taxpayers.

The criticism of Walmart focused on not only the numbers covered by health insurance but also the cost of insurance to employees, which deterred many associates from enrolling. Walmart offered several health insurance plans with different premium costs and levels of coverage. However, on average, associates with Walmart health insurance spent 8 percent of their income on health care, including premiums, deductibles, and out-of-pocket expenses. This figure is nearly double the national average. Associates with coverage for a spouse spent, on average, 13 percent of their income for health care.

In 2005, Walmart sought to make insurance more affordable by introducing a Value Plan, with premiums as low as \$11 a month. The \$11 premium was available in only a few states, however.

- For most workers the costs were, on average, \$25 for an individual, \$37 for a single parent, and \$65 for a family.
- The plan had a deductible of \$1,000, although three doctor visits were allowed before the deductible was applied.
- In addition, the insured were required to pay \$300 out of pocket for drugs and \$1,000 for a hospital stay before insurance took over payment for these items.

Thus, in a year, a family paying \$780 for insurance might have to pay \$2,300 in deductibles and out-of-pocket expenses. Critics questioned the value of the Value Plan for Walmart associates, most of whom earn less than \$20,000 annually.

### Obstacles for Walmart

Walmart and other retail employers face a number of obstacles to providing health benefits.

- First, in 2005, approximately 20 percent of the company’s workforce consisted of part-time workers, and many



others were new hires. Generally, the health benefits costs are the same whether a worker is full- or part-time. This factor increases the total cost to employers with a large percentage of part-time workers, if they are offered health benefits.

- Second, worker turnover, which is typical in retail, increases the number of workers employed over the course of a year. Enrolling workers who leave after a short period of enrollment imposes an administrative burden on employers and provides little benefit for employees. Most employers deal with this problem by imposing waiting periods before workers can enroll in a health insurance plan. At Walmart, full-time employees were eligible after six months of employment, and part-time employees, after two years. However, the longer the waiting period is, the larger will be the number of uninsured workers.
- Third, the design of the health insurance plan affects the number of workers who enroll. Plans that cover most costs with few deductibles and co-pays require large premiums, which tend to discourage low-wage workers from enrolling. Low premiums boost enrollment by low-wage workers but may create financial hardship when serious illness or injury leads to considerable out-of-pocket expenses.

Consequently, Walmart and other retailers who want to maximize the enrollment percentage must consider such questions as whether to offer health insurance for part-time employees, how long to make the waiting periods for full- and part-time workers, and what trade-offs to make between the cost of premiums on the one hand and the amount of deductibles and co-pays on the other. Generally, the trade-offs will be different for industries with a low-wage, heavily part-time workforce than for those with highly paid full-time employees.

Because the retail industry employs a workforce with different characteristics than many other industries, the question also arises whether the health benefits offered by Walmart should be compared with its other retail competitors or with all employers. Critics generally cite figures from all industries, while Walmart and other retailers contend that they should be compared only with each other. For example, the 60 percent of eligible associates who participate in the Walmart health insurance plan is only slightly below the 63 percent figure for all retailers, but significantly below the 83 percent national average. And the 73 percent of associates who were eligible for health insurance in 2005 is less than other large employers (79%) but well above the 61 percent average in the retail industry.

The cost of health benefits at Walmart, as at most companies, is substantial and increasing. In 2005, Walmart spent \$1.5 billion on health insurance, which is \$2,660 per insured associate. From 2002 to 2005, this cost

rose 19 percent each year. This increase was due not only to rising health care costs but also to greater utilization of health care services by associates, which was increasing at a rate of 10 percent per year. Among the factors contributing to this increase in utilization were that the Walmart workforce was aging faster than the general population and was becoming less healthy, due mainly to diseases related to obesity. In addition, Walmart associates tended to utilize health care inefficiently, in part by skimping on preventive medicine and relying too much on emergency rooms and hospital services. Compounding these problems was the fact that the least healthy associates were more satisfied with their benefits and more inclined to stay with the company.

### Walmart's Response

The challenge facing Walmart in 2005 was twofold: to reduce the rate of increase in health benefits and to spend the money available in the best way. This task fell to Walmart's vice-president for benefits, M. Susan Chambers, who produced a confidential memo with a number of controversial proposals. The memo proposed that the waiting time for part-time employees to be eligible for health insurance be reduced from two years to one and that the waiting time for all new employees be changed from a fixed period of time to the number of hours worked. Another proposal was to assist new employees in finding private health insurance until they were eligible for the company's plan. The problem of inefficient utilization of health care services was addressed by proposals to educate associates about health care and health insurance and to avoid emergency room visits by putting health clinics in stores.

The memo also proposed to cut costs by reducing enrollment of spouses, hiring more part-time workers, and discouraging unhealthy people from working at Walmart. The percentage of workers enrolled in the company's health insurance plan would not be affected if spouse coverage—which is an expensive option—were made less attractive. Increasing the percentage of part-time workers would decrease the enrollment in the company's health insurance plan. Additional cost savings would be realized if already insured full-time associates worked longer hours, since this would reduce the total number of full-time associates required. Workers in poor health could be discouraged from applying for a job or, once hired, from remaining at Walmart if some moderate physical activity were incorporated into all jobs. For example, ordinarily sedentary checkout clerks might also be required to gather shopping carts in the parking lot. The memo observed, "It will be far easier to attract and retain a healthier work force than it would be to change behavior in an existing one."<sup>89</sup>

In April 2006, Susan Chambers was replaced as vice president for benefits, and her successor was told by Walmart CEO H. Lee Scott, Jr., "We need you to go make

a difference in health care.”<sup>90</sup> The eligibility waiting period for part-time workers was reduced to one year, and for 2008, associates could choose from a broad range of more affordable plans to suit many different needs. Walmart claimed at the beginning of 2008 that the percentage of eligible employees enrolled in a company plan was 50.2 percent and that 92.7 percent of its eligible associates were covered by some form of health insurance. Walmart announced a study of why 7.3 percent of eligible associates declined to enroll. Critics complained that the company’s health insurance was still too expensive for low-wage workers. However, Walmart’s health benefits were now more generous than most of its competitors in the retail industry, though they continued to lag behind the health insurance offered by most major American employers.

### SHARED WRITING: HEALTH BENEFITS AT WALMART

Given Walmart’s struggle to provide its employees with more affordable health insurance coverage, as well as the overall costs associated with coverage, some concluded that Walmart fulfilled its obligation as one of the largest U.S. employers. Develop a case for and against this conclusion.

Review and comment on at least two classmates’ responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

### Chapter 8 Quiz: Employment Rights

# Chapter 9

# Health and Safety



## Learning Objectives

- 9.1** Explain the nature of ethical issues regarding occupational health and safety, employers' obligations to protect their employees, and the arguments over the extent of employers' responsibilities for injury or harm
- 9.2** Analyze the rights of employees to be informed about potential health and safety hazards and to refuse hazardous work, the justifications for these rights, and the difficulties they create for employers
- 9.3** Assess the risks posed by reproductive hazards in the workplace and the problems with fetal protection policies, including issues of discrimination, choice, and legal liability
- 9.4** Identify the responsibilities of manufacturers and consumers regarding harmful products, the ethical basis for three main theories defining these responsibilities, and problems with applying each theory

### Case: The Ford–Firestone Brawl

For almost 100 years, Firestone Tire and Rubber Company had supplied tires to Ford Motor Company. This venerable business relationship, which sprang from the close friendship of Harvey Firestone and Henry Ford at the beginning of the automotive age, was being sorely strained by a dispute between these longtime partners over problems with the Firestone tires installed on Ford's popular Explorer sport utility vehicle (SUV). By 2001, 203 deaths and over 700 injuries had resulted from rollovers in the Ford Explorer after the tread of Firestone tires separated. The showdown came at a meeting on May 21, 2001, when three senior Ford executives flew to Firestone's Nashville, Tennessee, headquarters to discuss the cause of these tragic incidents with Firestone's chief executive John Lampe.

#### Problems Emerge

Both Ford and Bridgestone/Firestone (Firestone merged with the Japanese tire manufacturer Bridgestone in 1988) had long been aware of safety problems with the Ford Explorer equipped with Firestone tires. When the development of a new SUV was begun in 1986, Ford executives insisted that the vehicle be cheap to produce and in production quickly. The solution that Ford engineers proposed was to bolt a passenger cabin to the chassis of the existing Ranger pickup truck. For additional cost and time savings, the vehicle could be built on the available Ranger assembly line. Initial tests on the prototype, code-

named UN46, showed the vehicle to be unstable. It was prone to tipping when cornering or changing lanes and to rolling over in the event of a tire failure.

Road performance could be improved by widening the wheelbase and lowering the center of gravity, but instead of these costly improvements, Ford engineers proposed softening the suspension system and lowering the pressure on the tires. Rather than the prescribed 30 to 35 pounds per square inch (psi), the engineers recommended 26, even though low-pressure tires create more heat, especially in hot climates. In February 1989, tests of Firestone tires at 29 psi showed "a severe 'tread package' separation from the tire carcass."<sup>1</sup> The soft suspension system as well as the heavier weight of the Explorer compared to the Ranger truck (600 pounds more) further contributed to the heat buildup. When the lower tire pressure reduced fuel efficiency, Ford ordered Firestone to cut the weight of the tires by 3 percent in order to meet federal Corporate Average Fuel Economy (CAFE) standards.<sup>2</sup>

Soon after the Ford Explorer hit the market in March 1990, reports of tire failure followed by rollovers were received by both Ford and Firestone. The first complaints came from the Middle East and Venezuela, where rough road conditions were common. Drivers in Saudi Arabia and other Persian Gulf countries often lowered the tire pressure to gain traction on sand and neglected to add air for highway driving. Ford quietly replaced the original Firestone tires on thousands of vehicles outside the United States without calling the action

a recall or reporting it to the National Highway Traffic Safety Agency (NHTSA). Reports of tire failure in the United States involving Firestone tires came largely from Florida, Texas, Arizona, and other warm-weather states.

On August 9, 2000, Firestone, which had been tracking warranty claims and other reports of tire failure, announced a recall of all 15-inch ATX and ATX II tires, as well as all Wilderness AT tires made at Firestone's Decatur, Illinois, plant. This recall covered an estimated 6.5 million tires still in use. Firestone engineers determined that a design flaw in the ATX tires resulted in cracking in the so-called shoulder pockets, which are scalloped areas on the side of the tire that give traction in snow and soil.<sup>3</sup> In addition, the Decatur plant, which endured a bitter strike in the years 1994 to 1996 that led to the production of inferior tires, used rubber pellets, which did not fuse as well as the rubber sheets used at other Firestone facilities. Despite these defects, there were few reports of tire failures involving Firestone ATX tires installed on the lighter Ranger pickup truck.

### Who was ultimately responsible for these accidents?

#### Compare Your Thoughts

By the time of the recall, it was evident that whatever the design flaws in the Ford Explorer and the Firestone ATX tires, the combination of the two—an Explorer equipped with Firestone tires—was a dangerously defective product.

Firestone executives insisted that its tires were safe when installed on appropriate vehicles but that Ford was at fault in installing them on the Explorer. Tire failures on Explorers would not be so severe, they added, if the vehicle were not so prone to rollovers. Moreover, they held that the search for causes should focus, to some extent, on the design of the Explorer. In testimony before a congressional committee investigating the rollover deaths, Mr. Lampe noted that there had been 16,000 rollovers of Explorers and that tire failure had been the cause of less than 10 percent of those accidents.<sup>4</sup> He also observed that more than 80 percent of the failures occurred on the rear wheels and more than half of those on the left rear tire, which suggests a fault with vehicle design rather than tire defects.<sup>5</sup> Firestone also faulted Ford for addressing the Explorer's instability by recommending the lower tire pressure and also for steadily increasing the weight of the Explorer during the mid-1990s, which further eroded the tires' margin of safety. Consumers were also at fault, they claimed, for not maintaining proper inflation and making repairs correctly.<sup>6</sup>

Jacques Nasser, the CEO of Ford, countered, "This is a tire issue, not a vehicle issue."<sup>7</sup> Ford released data showing that during a five-year period, Firestone tires on 1996 Explorers were involved in 30 fatal accidents per million tires produced while Explorers equipped with Goodyear tires were involved in only 3 fatal accidents per million tires produced, one-tenth the number.<sup>8</sup> Although automobile manufacturers dictate tire specifications to their suppliers, Firestone still chose to provide the tires for the Explorer that Ford demanded. Interestingly, Goodyear stopped supplying tires to Ford in 1997 because executives decided that they could not meet their own quality standards at the price that Ford was willing to pay.<sup>9</sup> Despite numerous warranty claims, though, Firestone failed to recognize the seriousness of the problem and to share the information with Ford. One reason for these failures is that after the merger of Firestone with Bridgestone, the database of warranty claims remained in Akron, where Firestone was located, while the database on damages was moved to Nashville, the home of Bridgestone.<sup>10</sup> Once the problem was recognized, Firestone issued a recall for the 15-inch ATX and ATX II tires but not the 16- and 17-inch tires, which some believed were also defective.

Prior to the May 21 meeting, each side had provided the other with some of the auto safety data they had collected.

It soon became apparent that each company was interpreting the data differently and using them to place responsibility on the other.<sup>11</sup>

The Ford executives would not comment on a report that the company was preparing to replace virtually all suspect Firestone tires on its Explorers, and they refused a request to conduct a joint investigation into the safety of the vehicle. What they wanted to talk about instead was data that suggested problems with yet other Firestone tires. At that point, John Lampe handed the Ford executive a letter he had composed in advance, severing all relations between Firestone and Ford. The next day, Ford announced the company would replace 13 million Firestone tires at a cost of \$3 billion.<sup>12</sup> Jacques Nasser was surprised that Firestone would walk away from \$7.5 billion in annual sales, which was 40 percent of Bridgestone/Firestone's global revenues. Mr. Lampe, in his letter addressed to Mr. Nasser, wrote, "Business relationships, like personal ones, are built on trust and mutual respect." He explained, "We have come to the conclusion that we can no longer supply tires to Ford since the basic foundation of our relationship has been seriously eroded."<sup>13</sup> Thus, the relationship forged by Harvey Firestone and Henry Ford a century ago came to an end amid mutual recriminations.

## Points to Consider . . .

Health and safety are paramount considerations in business, as well as in life generally. To some extent, consumers have a right to be protected against the risk of injury and

death from the products they purchase, and workers have a similar right to be protected against some workplace hazards. The rights that consumers and workers possess with regard to health and safety constitute a moral minimum that businesses ought to respect, but the level of protection

that is generally provided and also widely expected exceeds any right-based moral minimum. Regardless of whether Ford or Firestone violated any consumers' rights to safe products, the Ford Explorer equipped with Firestone tires was hazardous beyond any reasonable standard of safety. So, in addition to the level of health and safety that consumers and workers have as a matter of right, there is a higher level of protection expected from companies that must be justified by some means other than rights.

In justifying any level of protection for health and safety, it must be recognized that not all products and workplace conditions can be made completely safe. Moreover, health and safety protections for consumers and workers can be secured only at some costs, which must be weighed against the benefits that are gained. Thus, the morally acceptable level of health and safety in both the consumer marketplace and the employment workplace depends on how much we, as consumers and as employees, value this kind of protection in comparison with other goods. As individuals and as a society, we must decide what level of health and safety is worth the cost. Such decisions are commonly made not only by regulators using cost-benefit analysis but also by consumers and workers themselves, acting in markets. That is, consumers and workers can often choose their preferred level of safety in the products they buy and the jobs they accept.

In addition to the determination of morally acceptable levels of health and safety, questions can also be raised about the right of employees to be given information about the workplace hazards to which they are exposed and their right to refuse to perform dangerous work without fear of dismissal or other reprisals. An especially difficult kind of case is posed by the fact that certain jobs pose a health threat to the fetus of a pregnant woman and to the reproductive capacities of both men and women. Some pregnant women and women of childbearing age are demanding the right to transfer out of jobs thought to pose reproductive hazards. On the other hand, employers who exclude pregnant women or women of childbearing age from certain jobs because of reproductive hazards are open to charges of sexual discrimination, especially when they do not show an equal concern for the reproductive risk to men.

This chapter is concerned with determining how questions about the rights of workers and consumers in matters of health and safety ought to be answered. At issue in these questions are not only the obligation of employers with respect to the rights of workers and consumers but also the justification for government regulation of workplace conditions and product safety, especially as conducted by such agencies as the Occupational Safety and Health Administration (OSHA) and the Consumer Products Safety Commission (CPSC). Many of the questions discussed in this chapter deal with specific regulatory standards and policies, which are the subject of intense controversy.

## 9.1: Rights in the Workplace

### 9.1 Explain the nature of ethical issues regarding occupational health and safety, employers' obligations to protect their employees, and the arguments over the extent of employers' responsibilities for injury or harm

Many workers live with the possibility of serious injury and death every day. For some workers, the threat comes from a major industrial accident, such as the collapse of a mine or a refinery explosion, or from widespread exposure to a hazardous substance, such as asbestos, which is estimated by the World Health Organization to cause 107,000 deaths each year.<sup>14</sup> The greatest toll on the workforce is exacted, however, by little-publicized injuries to individual workers, some of which are gradual, such as hearing loss from constant noise or nerve damage from repetitive motions. Some of the leading causes of death, such as heart disease, cancer, and respiratory conditions, are thought to be job-related, although causal connections are often difficult to make. Even stress on the job is now being recognized as a workplace hazard that is responsible for headaches, back and chest pains, stomach ailments, and a variety of emotional disorders.

### 9.1.1: Meaning of Health and Safety

Although the term "safety" is often used to encompass all workplace hazards, it is useful to make a distinction between *safety* and *health*.<sup>15</sup> Safety hazards generally involve loss of limbs, burns, broken bones, electrical shocks, cuts, sprains, bruises, and impairment of sight or hearing. These injuries are usually the result of sudden and often violent events involving industrial equipment or the physical environment of the workplace. Examples include coming into contact with moving parts of machinery or electrical lines, getting hit by falling objects or flying debris, chemical spills and explosions, fires, and falls from great heights.

Health hazards are factors in the workplace that cause illnesses and other conditions that develop over a lifetime of exposure. Many diseases associated with specific occupations have long been known. In 1567, Paracelsus identified pneumoconiosis, or black lung disease, in a book entitled *Miners' Sickness and Other Miners' Diseases*. Silicosis, or the "white plague," has traditionally been associated with stonemasons. Other well-known occupational diseases are caisson disease among divers, cataracts in glassblowers, skin cancer among chimney sweeps, and phosphorus poisoning in matchmakers. Mercury poisoning, once common among felt workers, produces tremors, known as "the hatters' shakes," and delusions and hallucinations, which gave rise to the phrase "mad as a hatter."

In the modern workplace, most occupational health problems result from routine exposure to hazardous substances. Among these substances are:

- **fine particles**, such as asbestos, which causes asbestosis, and cotton dust, which causes byssinosis;
- **heavy metals**, such as lead, cadmium, and beryllium;
- **gases**, including chlorine, ozone, sulfur dioxide, carbon monoxide, hydrogen sulfide, and hydrogen cyanide, which damage the lungs and often cause neurological problems;
- **solvents**, such as benzene, carbon tetrachloride, and carbon disulfide;
- **certain classes of chemicals**, especially phenols, ketones, and epoxies;
- **pesticides** that pose a serious threat to agricultural workers, and
- **radioactive substances/radiation**, which are an occupational hazard to x-ray technicians and workers in the nuclear industry.

Because occupationally related diseases result from long-term exposure and not from identifiable events on the job, employers have generally not been held liable for them, and they have not, until recently, been recognized in workers' compensation programs. The fact that the onset of many diseases occurs years after the initial exposure—30 or 40 years in the case of asbestos—hides the causal connection. The links are further obscured by a multiplicity of causes. The textile industry, for example, claims that byssinosis among its workers results from their own decision to smoke and not from inhaling cotton dust on the job.<sup>16</sup> Lack of knowledge, especially about cancer, adds to the difficulty of establishing causal connections.

### How does the government regulate occupational health and safety conditions?

#### The OSH Act

Prior to the passage of the Occupational Safety and Health Act (OSH Act) in 1970, government regulation of occupational health and safety was almost entirely the province of the states. Understaffed and underfunded, the agencies charged with protecting workers in most states were not very effective.<sup>17</sup> Only a small percentage of workers in many states were even under the jurisdiction of regulatory agencies; often, powerful economic interests were able to influence their activities. Because the agencies lacked the resources to set standards for exposure to hazardous substances, they relied heavily on private standard-setting organizations and the industries themselves. The emphasis in most states was on education and training, and prosecutions for violations were rare. State regulatory agencies were also concerned almost exclusively with safety rather than with health.

States still play a major role in occupational health and safety through workers' compensation systems, but in 1970, primary responsibility for the regulation of working conditions passed to the federal government. The "general duty clause" of the OSH Act requires employers "to furnish to each of his employees employment and a place of employment which are free from recognized hazards that are causing or are likely to cause death or serious injury."<sup>18</sup> In addition, employers have a specific duty to comply with all the occupational safety and health standards that OSHA, the agency created by the Act, is empowered to make. Employees also have a duty, under Section 5(b), to "comply with occupational safety and health standards and all rules, regulations, and orders issued pursuant to this Act which are applicable to his own actions and conduct." OSHA regulates occupational health and safety primarily by issuing standards, which are commonly enforced by workplace inspections. Examples of standards are permissible exposure limits for toxic substances and specifications for equipment and facilities, such as guards on saws and the height and strength of railings.

## 10 Most Common OSHA Violations in 2014

1. Lack of protection against falls\*
2. Poor communication about hazardous chemicals
3. Improper scaffolding\*
4. Insufficient reduction of air contaminants
5. Below standard industrial truck operation
6. Improper operation of electrical equipment
7. Unsafe weight loads for ladders\*
8. Unacceptable electrical wiring
9. Lack of machine guards
10. Unacceptable electrical systems

\* Related to safety standards for construction

Source: OSHA, "Top 10 Most Frequently Cited Standards"

### 9.1.2: Protecting Health and Safety

At first glance, the right of employees to a safe and healthy workplace might seem to be too obvious to need any justification. This right—and the corresponding obligation of employers to provide working conditions free of recognized hazards—appears to follow from a more fundamental right, namely, the right of survival. Patricia H. Werhane writes, for example, "Dangerous working conditions threaten the very existence of employees and cannot be countenanced when they are avoidable." Without this right, she argues, all other rights lose their significance.<sup>19</sup>

Some other writers base a right to a safe and healthy workplace on the Kantian ground that persons ought to be treated as ends rather than as means. Thus, Mark MacCarthy argues that a right to work free from job-related diseases and injury follows from a more basic right people have to protect themselves from those who would use them for their own ends.<sup>20</sup>

Congress, in passing the OSH Act granting to all employees the right of a safe and healthy workplace, was apparently relying on a cost-benefit analysis, balancing the cost to industry with the savings to the economy as a whole. Congress, in other words, appears to have been employing essentially utilitarian reasoning. Regardless of the ethical reasoning used, though, workers have an undeniable right not to be injured or killed on the job.

It is not clear, though, what specific protection workers are entitled to or what specific obligations employers have with respect to occupational health and safety.

One position, recognized in common law, is that workers have a right to be protected against harm resulting directly from the actions of employers where the employer is at fault in some way. In most workplace accidents, however, employers can defend themselves against the charge of violating the rights of workers with two arguments. One is that their actions were not the *direct cause* of the death or injury and the other is that the worker *voluntarily assumed the risk*. These defenses are considered in turn.

**CONCEPT OF DIRECT CAUSE** Two factors enable employers to deny that their actions are a direct cause of an accident in the workplace.<sup>21</sup>

**One factor is that industrial accidents are typically caused by a combination of things, frequently including the actions of workers themselves.** When there is such a multiplicity of causes, it is difficult to assign responsibility to any one person.<sup>22</sup> The legal treatment of industrial accidents in the United States incorporates this factor by recognizing two common-law defenses for employers: A workplace accident was caused in part by (1) lack of care on the part of the employee (the doctrine of “contributory negligence”) or by (2) the negligence of coworkers (the “fellow-servant rule”). As long as employers are not negligent in meeting minimal obligations, they are not generally held liable for deaths or injuries resulting from industrial accidents.

**The second factor is that it is often not practical to reduce the probability of harm any further.** It is reasonable to hold an employer responsible for the incidence of cancer in workers who are exposed to high levels of a known carcinogen, especially when the exposure is avoidable. But a small number of cancer deaths can statistically be predicted to result from very low exposure levels to some widely used chemicals. Is it reasonable to hold employers responsible when workers contract cancer from

exposure to carcinogens at levels that are considered to pose only a slight risk?

Although workers have a right to accept or refuse jobs with risks, do they have sufficient information and adequate alternatives to make their choices truly voluntary?

The so-called Delaney Clause, a 1958 amendment to the Federal Food, Drug, and Cosmetic Act of 1938, for example, forbade the use of any food additive found to cause cancer.<sup>23</sup> Such an absolute prohibition is practicable for food additives, because substitutes are usually readily available. But when union and public interest groups petitioned OSHA in 1972 to set zero tolerance levels for 10 powerful carcinogens, the agency refused on the ground that workers should be protected from carcinogens “to the maximum extent practicable *consistent with continued use*.”<sup>24</sup> The practical difficulties of enforcing an absolute prohibition combined with improved technology in detecting levels of carcinogens led Congress in 1996 to quietly remove the Delaney Clause in new protective legislation.<sup>25</sup>

The position of OSHA in refusing to set a zero tolerance level was, apparently, that it is unreasonable to forgo the benefit of useful chemicals when there are no ready substitutes and the probability of cancer can be kept low by strict controls. This is also the position of philosopher Alan Gewirth, who argues that the right of persons not to have cancer inflicted on them is not absolute. He concluded, “Whether the use of or exposure to some substance should be prohibited should depend on the degree to which it poses the risk of cancer . . . . If the risks are very slight . . . and if no substitutes are available, then use of it may be permitted, subject to stringent safeguards.”<sup>26</sup>

This issue arose again in 1977 in a case involving benzene, a hazardous chemical with well-documented effects.

### **Why was exposure to benzene not prohibited? Was benzene proven to be the direct cause of illness?**

Because of benzene’s toxicity, a permissible exposure limit (PEL) of 10 parts per million (ppm) was set by OSHA. The assumption that exposure below the level of 10 ppm is safe was challenged in 1977 when a disproportionate number of leukemia deaths occurred at two rubber pliofilm plants in Ohio.<sup>27</sup> On the evidence contained in a report by the National Institute for Occupational Safety and Health (NIOSH), OSHA declared benzene to be a leukemia-causing agent and issued an emergency temporary standard ordering that the PEL for benzene in most work sites be reduced to 1 ppm until a hearing could be conducted on setting a new limit. OSHA was acting under a section of the law that requires the PEL for a known carcinogen to be set at the lowest technologically feasible level that will not impair the viability of the industries being regulated.

In the resulting uproar, the American Petroleum Institute, a trade association of domestic oil companies, contended

that the evidence linking benzene to leukemia was not conclusive and that the exposure standard should take into account the cost of compliance. Previous studies had documented the incidence of leukemia only at exposures above 25 ppm. One study of exposure below 10 ppm, conducted by Dow Chemical Company, found 3 leukemia deaths in a group of 594 workers, where 0.2 deaths would be expected, but it was impossible to rule out other causes, because the workers who developed leukemia had been exposed to other carcinogens during their careers. OSHA was unable to demonstrate, therefore, that exposure to benzene below the level of 10 ppm had ever caused leukemia and was thus a direct cause below this level.

**VOLUNTARY RISK ASSUMPTION** A second common-law defense is that employees voluntarily assume the risk inherent in work. Some jobs, such as coal mining, construction, longshoring, and meatpacking, are well known for their high accident rates, and yet some individuals freely choose these lines of work even when safer employment is available. The risk itself is sometimes part of the allure, but more often the fact that hazardous jobs offer a wage premium in order to compensate for the greater risk leads workers to prefer them to less hazardous, less-well-paying jobs. Like people who choose to engage in risky recreational activities, such as mountain climbing, workers in hazardous occupations, according to the argument, knowingly accept the risk in return for benefits that cannot be obtained without it. Injury and even death are part of the price they may have to pay. And except when an employer or a fellow employee is negligent in some way, workers who have chosen to work under dangerous conditions have no one to blame but themselves.

A related argument is that occupational health and safety ought not to be regulated because it interferes with the freedom of individuals to choose the kind of work that they want to perform. Workers who prefer the higher wages of hazardous work ought to be free to accept such employment, and those with a greater aversion to risk ought to be free to choose other kinds of employment or to bargain for more safety, presumably with lower pay. To deny workers this freedom of choice is to treat them as persons incapable of looking after their own welfare.<sup>28</sup> W. Kip Viscusi, who served as a consultant to OSHA during the Reagan administration, adds an extra twist by arguing that programs designed to keep workers from being maimed and killed on the job effectively deprive them of the opportunity to select risky but good-paying jobs and thus are a form of class oppression in which the rich impose their risk preferences on the poor.<sup>29</sup>

Workers have a right to accept or refuse risky jobs, and they assume all responsibility for the risks in the jobs they accept.

The argument that employees assume the risk of work can be challenged on several grounds.

**First, workers need to possess a sufficient amount of information about the hazards involved.** They cannot be said to assume the risk of performing dangerous work when they do not know what the risks are. Also, they cannot exercise the right to bargain for safer working conditions without access to the relevant information. Yet, employers have generally been reluctant to notify workers or their bargaining agents of dangerous conditions or to release documents in their possession. Oftentimes, hazards in the workplace are not known by the employer or the employee until after the harm has been done. In order for employers to be relieved of responsibility for injury or death in the workplace, though, it is necessary that employees have adequate information *at the time they make a choice*.

**Second, employees' choices must be truly free.** When workers are forced to perform dangerous work for lack of acceptable alternatives, they cannot be said to assume the risk. For many people with few skills and limited mobility in economically depressed areas, the only work available is often in a local slaughterhouse or textile mill, where they run great risks. Whether they are coerced into accepting work of this kind is a controversial question. Individuals are free in one sense to accept or decline whatever employment is available, but the alternatives of unemployment or work at poverty-level wages may be so unacceptable that people lack freedom of choice in any significant sense.

**RISK AND COERCION** In order to determine whether workers assume the risk of employment by their free choice, we need some account of the concept of coercion. A paradigm example is the mugger who says with a gun in hand, "Your money or your life." The "choice" offered by the mugger contains an undesirable set of alternatives that are imposed on the victim by a threat of dire consequences. A standard analysis of coercion that is suggested by this example involves two elements:

1. getting a person to choose an alternative that he or she does not want and
2. issuing a threat to make the person worse off if he or she does not choose that alternative.

Consider the case of an employer who offers a worker who already holds a satisfactory job higher wages in return for taking on new duties involving a greater amount of risk.<sup>30</sup> The employer's offer is not coercive because there is no threat involved. The worker may welcome the offer, but declining it leaves the worker still in possession of an acceptable position. Is an employer acting like a mugger, however, when the offer of higher pay for more dangerous work is accompanied by the threat of dismissal? Is "Do this hazardous work or be fired!" like or unlike the "choice" offered by the mugger? The question is even more difficult when the only "threat" is not to hire a person. Is it coercive to say, "Accept this dangerous job or stay unemployed!"



because the alternative of remaining out of work leaves the person in exactly the same position as before? Remaining unemployed, moreover, is unlike getting fired, in that it is not something that an employer inflicts on a person.

Does an employer's offer of a risky job to an unemployed worker involve coercion?

In order to answer this question, the standard analysis of coercion needs to be supplemented by an account of what it means to issue a threat. A threat involves a stated intention of making a person worse off in some way. To fire a person from a job is usually to make that person worse off, but we would not say that an employer is coercing a worker by threatening dismissal for failure to perform the normal duties of a job. Similarly, we would not say that an employer is making a threat in not hiring a person who refuses to carry out the same normal duties. A person who turns down a job because the office is not provided with air conditioning, for example, is not being made worse off by the employer. So why would we say that a person who chooses to remain unemployed rather than work in a coal mine that lacks adequate ventilation is being coerced?

The answer of some philosophers is that providing employees with air conditioning is not morally required; however, maintaining a safe mine is. Whether a threat is coercive because it would make a person worse off can be determined only if there is some baseline that answers the question: Worse off compared with what? Robert Nozick gives an example of an abusive slave owner who offers not to give a slave his daily beating if the slave will perform some disagreeable task the slave owner wants to be done.<sup>31</sup> Even though the slave might welcome the offer, it is still coercive, because the daily beating involves treating the slave in an immoral manner. For Nozick and others, what is *morally required* is the relevant baseline for determining whether a person would be made worse off by a threatened course of action.<sup>32</sup>

It follows from this analysis that coercion is an inherently ethical concept that can be applied only after determining what is morally required in a given situation.<sup>33</sup> As a result, the argument that the assumption of risk by employees relieves employers of responsibility involves circular reasoning. Employers are freed from responsibility for workplace injuries on the ground that workers assume the risk of employment only if they are not coerced into accepting hazardous work. But whether workers are coerced depends on the right of employees to a safe and healthy workplace—and the obligation of employers to provide it.

### What can we conclude about the right to occupational health and safety?

In conclusion, the right of employees to a safe and healthy workplace cannot be justified merely by appealing to a right

not to be injured or killed. The weakness of this argument lies in the difficulty of determining the extent to which employers are *responsible* for the harm that workers suffer as a result of occupational injuries and diseases. The argument applies only to dangers that are directly caused by the actions of employers; however, industrial accidents result from many causes, including the actions of coworkers and the affected workers themselves. The responsibility of employers is also problematical when the probability of harm from their actions is low. Moreover, the responsibility of employers is reduced insofar as employees voluntarily assume the risk inherent in employment. Whether the choice to accept hazardous work is voluntary, though, depends in part on difficult questions about the concept of coercion, which, on one standard analysis, can be applied only after the rights of employees in matters of occupational health and safety have been determined.

## 9.2: Hazardous Work

### 9.2 Analyze the rights of employees to be informed about potential health and safety hazards and to refuse hazardous work, the justifications for these rights, and the difficulties they create for employers

The following case involves workers who refused an order to work in an area where they might suffer injury or even death from falling, which is one of the most common causes of serious accidents in the workplace, as well as the most frequent violation of OSHA standards by employers.

**CASE: THE WHIRLPOOL CORPORATION** The Whirlpool Corporation operated a plant in Marion, Ohio, for the assembly of household appliances.<sup>34</sup> Components for the appliances were carried throughout the plant by an elaborate system of overhead conveyors. To protect workers from the objects that fall from the conveyors, a huge wire mesh screen was installed approximately 20 feet above the floor. The screen was attached to an angle-iron frame suspended from the ceiling of the building. Maintenance employees at the plant spent several hours every week retrieving fallen objects from the screen. Their job also included replacing paper that is spread on the screen to catch dripping grease from the conveyors, and sometimes they did maintenance work on the conveyors themselves. Workers were usually able to stand on the frame to perform these tasks, but occasionally it was necessary to step onto the screen.

In 1973, several workers fell partway through the screen, and one worker fell completely through to the floor of the plant below but survived. Afterward, Whirlpool began replacing the screen with heavier wire mesh, but on June 28, 1974, a maintenance employee fell to his death through a portion of the screen that had not been replaced. The

company responded by making additional repairs and forbidding employees to stand on the angle-iron frame or step onto the screen. An alternative method for retrieving objects was devised using hooks. Two maintenance employees at the Marion plant, Virgil Deemer and Thomas Cornwell, were still not satisfied. On July 7, 1974, they met with the maintenance supervisor at the plant to express their concern about the safety of the screen. At a meeting with the plant safety director two days later, they requested the name, address, and telephone number of a representative in the local OSHA office. The safety director warned the men that they “had better stop and think about what they were doing,” but he gave them the requested information. Deemer called the OSHA representative later that day to discuss the problem.

When Deemer and Cornwell reported for the night shift at 10:45 P.M. the next day, July 10, they were ordered by the foreman to perform routine maintenance duties above an old section of the screen. They refused, claiming that the work was unsafe, whereupon the foreman ordered the two employees to punch out. In addition to losing wages for the six hours they did not work that night, Deemer and Cornwell received written reprimands, which were placed in their personnel files.

### What choice did the two Whirlpool employees face?

The Whirlpool case illustrates a cruel dilemma faced by many American workers. If they stay on the job and perform hazardous work, they risk serious injury and even death. On the other hand, if they refuse to work as directed, they risk disciplinary action, which can include loss of wages, unfavorable evaluation, demotion, and even dismissal. Many people believe that it is unjust for workers to be put into the position of having to choose between safety and their job. Even worse are situations in which workers face hazards of which they are unaware. Kept in the dark about dangers lurking in the workplace, employees have no reason to refuse hazardous work and are unable to take other steps to protect themselves.

## WRITING PROMPT

### Employees Looking Out for Themselves

In the Whirlpool case, is the employee or the employer the better judge of whether the work was safe? Why would someone think that the employees should have been disciplined for refusing the order to engage in the hazardous work?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 9.2.1: Justifying a Right to Refuse

The right to refuse hazardous work is the right to refuse orders to perform hazardous work without fear of suffering adverse consequences. This right is different from a

right to a safe and healthy workplace. If it is unsafe to work above the old screen, as Deemer and Cornwell contended, then their right to a safe and healthy workplace was violated. A right to refuse hazardous work, however, is only one of several alternatives that workers have for securing the right to a safe and healthy workplace. Victims of racial or sexual discrimination, for example, also suffer a violation of their rights, but it does not follow that they have a right to disobey orders or to walk off the job in an effort to avoid discrimination. Other means are available for ending discrimination and for receiving compensation for the harm done. The same is true for the right to a safe and healthy workplace.

The main argument for denying workers a right to refuse hazardous work is that such a right conflicts with the obligation of employees to obey all reasonable directives from an employer. An order for a worker to perform some especially dangerous task may not be reasonable, however. The foreman in the *Whirlpool* case, for example, was acting contrary to a company rule forbidding workers to step on the screen. Still, a commonly accepted principle is that employees obey even an improper order and file a grievance afterward, if a grievance procedure is in place, or seek whatever other recourse is available. The rationale for this principle is that employees may be mistaken about whether an order is proper, and chaos would result if employees could stop work until the question is decided. It is better for workers to obey now and correct any violation of their rights later.

The fatal flaw in this argument is that later may be too late. The right to a safe and healthy workplace, unlike the right not to be discriminated against, can effectively provide protection for workers only if violations of the right are prevented in the first place. Debilitating injury and death cannot be corrected later; neither can workers and their families ever be adequately compensated for a loss of this kind. The right to refuse hazardous work, therefore, is necessary for the existence of the right to a safe and healthy workplace.

**CONDITIONS FOR JUSTIFIED REFUSAL** A right to a safe and healthy workplace is empty unless workers have a right in some circumstances to refuse hazardous work, but there is a tremendous amount of controversy over what these circumstances are. In the *Whirlpool* case, the Supreme Court cited two factors as relevant for justifying a refusal to work:

1. the employee reasonably believes that the working conditions pose an imminent risk of death or serious injury and
2. the employee has reason to believe that the risk cannot be avoided by any less disruptive course of action.

Employees have a right to refuse hazardous work, in other words, only as a last resort—when it is not possible

to bring unsafe working conditions to the attention of the employer or to request an OSHA inspection. Also, the hazards that employees believe exist must involve a high degree of risk of serious harm. Refusing to work because of a slight chance of minor injury is less likely to be justified. The fact that a number of workers had already fallen through the screen at the Whirlpool plant, for example, and that one had been killed strengthens the claim that the two employees had a right to refuse their foreman's order to step onto it.

**STANDARDS OF REASONABLE BELIEF** The pivotal question, of course, is the proper standard for a reasonable belief.

How much evidence should employees be required to have in order to be justified in refusing to work? Or, should the relevant standard be the actual existence of a workplace hazard rather than the belief of employees, no matter how reasonable?

A minimal requirement, which has been insisted on by the courts, is that employees act in *good faith*. Generally, acting in good faith means that employees have an honest belief that a hazard exists and that their only intention is to protect themselves from the hazard. The “good-faith” requirement serves primarily to exclude refusals based on deliberately false charges of unsafe working conditions or on sabotage by employees. Whether a refusal is in good faith does not depend on the reasonableness or correctness of the employees’ beliefs about the hazards in the workplace. Thus, employees who refuse an order to fill a tank with a dangerous chemical in the mistaken but sincere belief that a valve is faulty are acting in good faith, but employees who use the same excuse to conduct a work stoppage for other reasons are not acting in good faith, even if it should turn out that the valve is faulty.

Three standards are commonly used for determining whether a good-faith refusal is based on a reasonable belief.

- One is the *subjective* standard, which requires only that employees have evidence that they sincerely regard as sufficient for their belief that a hazard exists or that most workers in their situation would regard as sufficient.
- At the opposite extreme is the *objective* standard. This standard requires evidence that experts regard as sufficient to establish the existence of a hazard.
- In between these two is the *reasonable person* standard, which requires that the evidence be strong enough to persuade a reasonable person that a hazard exists.

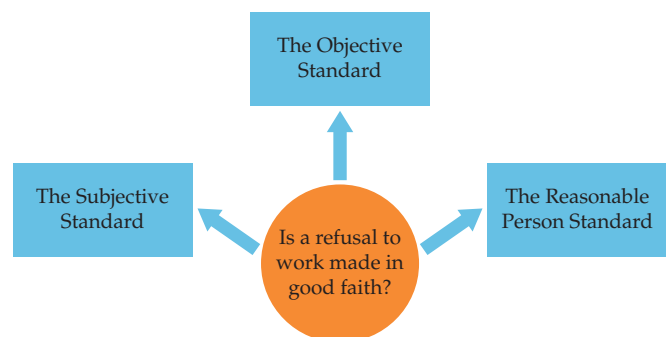
The subjective standard provides the greatest protection for worker health and safety. Employees cannot be expected to have full knowledge of the hazards facing them in the workplace. They may not be told what chemicals they are using, for example, or what exposure levels are safe for these chemicals. Safe exposure levels for the

chemicals may not even have been scientifically determined. Employees may also not have the means at the moment to measure the levels to which they are exposed. Yet, the objective standard forces employees to bear the consequences if their beliefs about the hazards present in the workplace cannot be substantiated. The reasonable person standard is less exacting because it requires only that employees exercise reasonable judgment. Still, this standard places a strong burden of proof on workers who have to make a quick assessment under difficult circumstances. A wrong decision can result in the loss of a job or possibly the loss of a worker's life.

On the other hand, the subjective standard allows employees to make decisions that are ordinarily the province of management. Management is usually better informed about hazards in the workplace, along with other aspects of the work to be performed, and so its judgment should generally prevail. To allow workers to shut down production on the basis of unsubstantiated beliefs, and thereby to substitute their uninformed judgment for that of management, is likely to result in many costly mistakes. The subjective standard creates no incentive for workers to be cautious in refusing hazardous work because the cost is borne solely by the company. The reasonable person standard, therefore, which places a moderate burden of proof on employees, is perhaps the best balance of the competing considerations.

Use Figure 9.1 to review these standards for determining whether an employee who refuses a risky assignment is acting in good faith.

**Figure 9.1** Assessing a Good-Faith Refusal



### WRITING PROMPT

#### Legitimate Refusals to Do Work

Explain why the “reasonable person” standard is the most appropriate means to determine whether an employee’s refusal to work is justified or not. What evidence can be provided to show that a refusal to work was made in good faith?

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## 9.2.2: Justifying a Right to Know

The right to know is actually an aggregation of several rights. Thomas O. McGarity classifies these rights by the correlative duties that they impose on employers, which are listed in Figure 9.2.<sup>35</sup>

**Figure 9.2** How Employers Fulfill Employees' Right to Know

Employers must...
1. Reveal information already possessed
2. Communicate information to employees
3. Seek out information from other sources
4. Produce new information through research

Advocates of the right of workers to know need to specify which of these particular rights are included in their claim. Disagreement also arises over questions about what information workers have a right to know and which workers have a right to know it. In particular, does the information that employers have a duty to reveal include information about the past exposure of workers to hazardous substances? Do employers have a duty to notify past as well as present employees? The issue at stake in these questions is a part of the “right to know” controversy commonly called *worker notification*.

Unlike the right to refuse hazardous work, the right to know about workplace hazards is not necessary for the right to a safe and healthy workplace.

This latter right is fully protected as long as employers succeed in ridding the workplace of significant hazards. Some argue that the right to know is still an effective, if not an absolutely essential, means for securing the right to a safe and healthy workplace. Others maintain, however, that the right to know is not dependent for its justification on the right to a safe and healthy workplace; that is, even employees who are adequately protected by their employers against occupational injury and disease still have a right to be told what substances they are handling, what dangers they pose, what precautions to take, and so on.

**ARGUMENT FROM AUTONOMY** The most common argument for the right to know is one based on autonomy. This argument begins with the premise that autonomous individuals are those who are able to exercise free choice in matters that affect their welfare most deeply.<sup>36</sup> Sometimes this premise is expressed by saying that autonomous individuals are those who are able to *participate* in decision making about these matters. One matter that profoundly affects the welfare of workers is the amount of risk that they assume in the course of earning a living. Autonomy requires, therefore, that workers be free to avoid hazardous work if they so choose, or have the opportunity to accept greater risks in return for higher pay if that is their choice.

In order to choose freely, however, or to participate in decision making, it is necessary to possess relevant information. In the matter of risk assumption, the relevant information includes knowledge of the hazards present in the workplace. Workers can be autonomous, therefore, only if they have a right to know.

### How do employers respond to this argument?

In response, employers maintain that they can protect workers from hazards more effectively than workers can themselves, without informing workers of the nature of those hazards. Such a paternalistic concern, even when it is sincere and well-founded, is incompatible, however, with a respect for the autonomy of workers. A similar argument is sometimes used to justify paternalism in the doctor–patient relationship. For a doctor to conceal information from a patient even in cases where exclusive reliance on the doctor’s greater training and experience would result in better medical care is now generally regarded as unjustified. If paternalism is morally unacceptable in the doctor–patient relationship where doctors have an obligation to act in the patient’s interest, then it is all the more suspect in the employer–employee relationship where employers have no such obligation.<sup>37</sup>

Although autonomy is a value, it does not follow that employers have an obligation to further it in their dealings with employees. The autonomy of buyers in market transactions is also increased by having more information, but the sellers of a product are not generally required to provide this information except when concealment constitutes fraud.<sup>38</sup> The gain of autonomy for employees must be balanced, moreover, against the not inconsiderable cost to employers of implementing a “right to know” policy in the workplace. In addition to the direct cost of assembling information, attaching warning labels, training workers, and so on, there are also indirect costs. Employees who are aware of the risk they are taking are more likely to demand either higher wages or safer working conditions. They are more likely to avail themselves of workers’ compensation benefits and to sue employers over occupational injury and disease. Finally, companies are concerned about the loss of valuable trade secrets that could occur from informing workers about the hazards of certain substances.

### WRITING PROMPT

#### Paying for a Right to Know

Suppose that a business compensates for the additional costs of implementing a “right to know” policy by laying off a number of workers, rather than charging more for the product or service it offers. Explain whether or not this is an acceptable trade-off.

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**BARGAINING OVER INFORMATION** An alternative to a right-to-know policy that respects the autonomy of both parties is to allow bargaining over information. Since acquiring information involves some cost, the employees must be willing to pay for it. However, economic theory suggests that employees would be willing to pay, perhaps in reduced wages, for any information that would protect them in the workplace as long as the benefit exceeds the cost.

Although promising in theory, this alternative is not practical. It creates a disincentive for employers, who possess most of the information, to yield any of it without some concession by employees, even when it could be provided at little or no cost. Bargaining is feasible for large unions with expertise in safety matters, but reliance on it would leave members of other unions and nonunionized workers without adequate means of protection. In the absence of a market for information, neither employers nor employees would have a basis for determining the value of information in advance of negotiations. Finally, there are costs associated with using the bargaining process to decide any matter—what economists call “transaction costs”—and these are apt to be quite high in negotiations over safety issues. It is unlikely, therefore, that either autonomy or worker health and safety would be well served by the alternative of bargaining over matters of occupational health and safety.

**UTILITARIAN ARGUMENTS** There are two broadly utilitarian arguments for the right to know as a means to greater worker health and safety.

1. **Enabling Self-Protection Measures.** One argument is based on the plausible assumption that workers who are aware of hazards in the workplace will be better equipped to protect themselves. Warning labels or rules requiring protective clothing and respirators are more likely to be effective when workers fully appreciate the nature and extent of the risks they are taking. Also, merely revealing information about hazardous substances in the workplace is not apt to be effective without extensive training in the procedures for handling them safely and responding to accidents. Finally, workers who are aware of the consequences of exposure to hazardous substances will also be more likely to spot symptoms of occupational diseases and seek early treatment.
2. **Determining Appropriate Wages.** The second utilitarian argument is offered by economists who hold that overall welfare is best achieved by allowing market forces to determine the level of acceptable risk. In a free market, wages are determined in part by the willingness of workers to accept risks in return for wages. Employers can attract a sufficient

supply of workers to perform hazardous work in one of two ways:

- by spending money to make the workplace safer, thereby reducing the risks, or
- by increasing wages to compensate workers for the greater risks.

The choice is determined by the marginal utility of each kind of investment. Thus, an employer will make the workplace safer up to the point that the last dollar spent equals the increase in wages that would otherwise be required to induce workers to accept the risks. At that point, workers indicate their preference for accepting the remaining risks rather than suffering a loss of wages in return for a safer workplace.

Unlike the autonomy argument, in which workers bargain over risk information, this argument proposes that workers bargain over the trade-off between risks and wages. In order for a free market to determine this trade-off in a way that achieves overall welfare, it is necessary for workers to have a sufficient amount of information about the hazards in the workplace. To the extent that workers lack this information, they will undervalue the risks they face and accept lower wages, which in turn will create no incentive for employers to increase the level of safety. The end result, according to Thomas O. McGarity, will be a loss of wealth as society covers the cost of more disease and injury.<sup>39</sup>

Although these two utilitarian arguments provide strong support for the right to know, they are both open to the objection that there might be more efficient means, such as more extensive OSHA regulation, for securing the goal of worker health and safety. Could the resources devoted to complying with a right-to-know law, for example, be better spent on formulating and enforcing more stringent standards on permissible exposure limits and on developing technologies to achieve these standards? Could the cost of producing, gathering, and disseminating information be better borne by a government agency than by individual employers? These are difficult empirical questions for which conclusive evidence is largely lacking.

## 9.3: Reproductive Hazards

### 9.3 Assess the risks posed by reproductive hazards in the workplace and the problems with fetal protection policies, including issues of discrimination, choice, and legal liability

A seldom considered but significant risk in the workplace is posed by *reproductive hazards*, which affect workers' capacity to conceive and bear children. The list of reproductive hazardous present in workplaces is long, encompassing chemical, biological, and radiological agents. The

problem of reproductive hazards puts companies using these agents in a very difficult position. Employers have a responsibility not to inflict harm, and this obligation extends, presumably, to the fetus of a pregnant female employee. However, the possible means for fulfilling this responsibility may conflict with some important rights held by workers, both women and men. In particular, *fetal protection policies*, which are now illegal, raise several ethical concerns, including a potential for discrimination.

### 9.3.1: Scientific Background

Substances harmful to a fetus are of three kinds.

- First, there are *fetotoxins*. These are toxic substances that affect a fetus in the same way that they affect an adult, although a fetus, because of the smaller size, may be harmed by exposure to substances below the permissible limits for adults.
- *Teratogens*, the second group of substances, interfere with the normal development of the fetus in utero. These may pose no danger to a fully developed person outside the womb but are hazardous to a developing fetus.
- Finally, some substances are *mutagens*, which damage genetic material before conception.

The effects of fetotoxins, teratogens, and mutagens are similar. They include infertility, spontaneous abortion, miscarriage, stillbirth, and congenital defects. Some defects, such as bodily deformities, are visible at birth, whereas others may be latent conditions that manifest themselves later, as in the case of childhood cancers.

Fetotoxins and teratogens (many substances are both) must be transmitted to the fetus through the mother. This can occur, however, when the father is exposed to a hazardous substance in the workplace and passes it on through physical contact. Studies show that the nonworking wives of men exposed to lead, beryllium, benzene, vinyl chloride, and anesthetic gases, for example, have higher-than-normal rates of miscarriage. Children of fathers exposed to asbestos and benzene are shown in studies to have a greater incidence of cancer. The most likely explanation for these correlations is that the hazardous substances are brought home on the father's body or on his clothing and other belongings.

The main reproductive hazard to men is posed by mutagenic substances because these are capable of altering the chromosomal structure of both the ovum and the sperm. Although the mutagenic effects of many suspected substances are not firmly established, some researchers theorize that most teratogens are also mutagens and that there is a strong connection between the three phenomena: teratogenesis, mutagenesis, and carcinogenesis (the development of cancers). The reason is that all three operate on the cellular

level by altering the DNA molecule.<sup>40</sup> If these relationships exist, then virtually any substance that poses a reproductive hazard to a woman is also hazardous to the reproductive capacity of a man and ultimately the health of a fetus.

### 9.3.2: Fetal Protection Policies

A typical fetal protection policy excludes women from holding certain jobs that involve exposure to reproductive risks, except when their inability to bear children is medically documented. Such a policy affects all women of child-bearing age unless they have undergone surgical sterilization or otherwise have proof of infertility. Instead of imposing a fetal protection policy, some companies have asked employees to sign waivers releasing them from responsibility, but this is an ineffective legal solution. Individuals can, under certain conditions, waive their own rights, but they cannot waive the right of their future children to sue for prenatal injuries.

Prior to 1991, many companies addressed the risks of reproductive hazards with the adoption of a fetal protection policy. However, in that year, the U.S. Supreme Court, in a landmark 9–0 decision, held fetal protection policies to be discriminatory, in violation of Title VII of the 1964 Civil Rights Act. Fetal protection policies were ruled to be discriminatory for the reason that they exclude women based only on their childbearing capacity and ignore the risk to men. Thus, the policy does not protect “effectively and equally” the offspring of all employees. Although the high court ruling eliminates one means of protecting against reproductive risks, these risks remain, and so the challenge for companies in meeting their responsibility to protect workers against reproductive hazards became even more acute after 1991.

In addition to their discriminatory effect, fetal protection policies were criticized for forcing women to undergo surgical sterilization in order to keep a current job or to be hired for or promoted to a new one.

#### Examples

- When five women were laid off by the Allied Chemical Company in 1977 because of concern for fetal damage by a substance known as Fluorocarbon 22, two of them underwent surgical sterilization in order to return to work. Shortly afterward, the company determined that Fluorocarbon 22 posed no threat to a developing fetus, so the women's loss of fertility was needless.<sup>41</sup>
- When the American Cyanamid Company announced the adoption of a fetal protection policy at a plant in Willow Island, West Virginia, in 1978, five women between the ages of 26 and 43 submitted to surgical sterilization in order to retain jobs that involved exposure to lead chromate, an ingredient of paint pigments. Two years later, American Cyanamid stopped producing paint pigments because of a decreased demand for the lead-based product.<sup>42</sup>

Employers insist that they do not encourage women to take the drastic step of undergoing surgical sterilization, but they also maintain that they have no control over such an intimate decision by female employees or by women seeking employment and that there is no reason to exclude women who undergo sterilization from jobs involving exposure to reproductive hazards. According to critics of fetal protection policies, however, companies that exclude fertile women from such jobs effectively force sterilization on those who have no other satisfactory employment opportunities. The problem is one of intentions versus results. Although there is no intention to force women to become sterile, employers create situations that have this result.

### 9.3.3: Charge of Discrimination

The Supreme Court ruling came in response to a class action suit against Johnson Controls (see Case: Johnson Controls, Inc.) brought by the employees' union on behalf of all workers, men as well as women.<sup>43</sup> At issue in this suit was not the need to protect workers against reproductive hazards but rather the means for doing so. In particular, the suit raised the important question of whether critical decisions about workplace protection should be made by employers or by employees. In opposing fetal protection policies, many women were claiming the right to decide for themselves whether to work at jobs that involve reproductive risks, rather than being subject to employers' decisions.

**WHO DECIDES?** Although women have a strong maternal interest in the health of an unborn child, they are also concerned about their own economic well-being and want to be free to choose the level and type of risk to themselves and their offspring that they feel are appropriate. Not only might a woman choose a higher level of risk than an employer's fetal protection policy would allow, but an individual could be more flexible than a company in choosing which risks to assume and for what period of time.

With regard to the problem of reproductive hazards, the usual positions of employers and employees have been reversed. Typically, workers have been more concerned than companies to respond quickly to new evidence of hazards. On fetal protection, however, business has taken an almost alarmist posture, whereas labor has urged a go-slow approach.<sup>44</sup> This reversal is not hard to understand. Protecting unborn children from harmful agents in the workplace and coping with the consequences of occupationally related birth defects involve substantial costs. Fetal protection policies are adopted by corporate managers who assume the right to make crucial decisions about how the fetus of an employee will be protected. The cost of these decisions is borne largely by women, however, who find their economic opportunities sharply limited.

According to estimates by the federal government, in 1980, at the time of the Johnson Controls case, at least 100,000 jobs were closed to women because of fetal protection policies already in place,<sup>45</sup> and as many as 20 million jobs would be closed if women were excluded from all work involving reproductive hazards.<sup>46</sup> The women most affected by the reduction in the number of jobs available are those with the fewest skills and the least education, who are already near the bottom of the economic ladder. Because they bear the heavy cost of fetal protection, women argue that they should be the ones to make the decisions involved in protecting their own offspring. Workers further claim that fetal protection policies are adopted by employers as a quick and cheap alternative to cleaning up the workplace. So, the costs that fetal protection policies impose on women result from efforts by companies to save money for themselves.

**ISSUES IN DISCRIMINATION** Whether employers have a right to adopt a fetal protection policy depends, in part, on whether excluding fertile women from certain jobs is a form of sex discrimination. The point at issue is not whether women are vulnerable to reproductive hazards (they certainly are), but whether men are vulnerable as well. If they are vulnerable, then it is discriminatory for employers to adopt a policy that applies only to women and not to men. The research on reproductive hazards, although inconclusive, suggests that fetal harm can result when either parent is exposed to hazardous substances. If that is in fact the case, then fetal protection policies should apply to both sexes. Wendy W. Williams argues, "There is simply no basis for resolving doubts about the evidence by applying a policy to women but not to men on the unsubstantiated generalization that the fetus is placed at greatest risk by workplace exposure of the pregnant woman."<sup>47</sup>

Fetal protection policies are also discriminatory if they are applied only to women who occupy traditionally male jobs and not to women in female-dominated lines of work where the hazard is comparable. Some critics charge that fetal protection policies have been used to discriminate by reinforcing job segregation through their selective application to women with jobs in areas formerly dominated by men, whereas the reproductive risks to other women have been ignored.

**Example:** American Cyanamid identified five substances in use at the Willow Island plant as suspected fetotoxins and notified 23 women in production jobs that they were exposed to reproductive hazards and would be transferred if they became pregnant. However, the fetal protection policy was applied only to the nine women who held comparatively high-paying jobs in the paint pigments department, which had formerly been reserved for men. Barbara Cantwell, one of the four women who submitted to sterilization in order to retain her job, remarked, "I smelled harassment when the problem was suddenly narrowed to the area where women worked."<sup>48</sup>

Among the women in traditionally female lines of work who are exposed to reproductive hazards are nurses in operating rooms, who have twice as many miscarriages as other women because of anesthetic gases; female x-ray technicians, who are twice as likely to bear defective children; and women who work in dry-cleaning operations, where petroleum-based solvents are used.<sup>49</sup> Yet there has been no movement in the industries employing these women to implement fetal protection policies similar to those in the male-dominated chemical, petroleum, and heavy-manufacturing industries.

### 9.3.4: Defending against the Charge

Distinctions based on sex are not always discriminatory. They are morally permissible if they have an adequate justification, and Title VII of the 1964 Civil Rights Act recognizes this by allowing employers two defenses.

- The weaker claim is that a sex-based policy is necessary for serving a *proper business purpose* (the business necessity defense).
- The stronger claim is that a person's sex is a *bona fide occupational qualification* (the BFOQ defense), absolutely necessary for the performance of the job.

Generally, for the business necessity defense, an employer must establish that a policy is needed for achieving a proper business objective in a safe and efficient manner and that the objective cannot reasonably be achieved by less discriminatory means. A successful business necessity defense for fetal protection policies must establish three key elements:

1. there is a substantial risk to a fetus;
2. this risk occurs only through women; and
3. there is no less discriminatory alternative.

Because of the nature of the discrimination from fetal protection policies, the Supreme Court held that only the BFOQ test was applicable in the Johnson Controls case.<sup>50</sup> The crucial phrase in the BFOQ defense, "reasonably necessary for the normal operation" of a business, has been interpreted by the courts to include "ethical, legal, and business concerns about the effects of an employer's activities on third parties." For example, the courts have ruled that age is a BFOQ for being an airline pilot because the safety of passengers depends on that person's performance.<sup>51</sup> Thus, a qualification may be a BFOQ if it is necessary for conducting business without greatly endangering other people.

Using this line of reasoning, it might be argued that sex is a BFOQ for working at a battery factory, because a pregnant or fertile woman is liable to expose a third party—namely, a fetus—to harm. However, the Supreme Court's view was that being a man or a nonfertile woman

was not a BFOQ because fertile and even pregnant women are as capable of manufacturing batteries as anyone else. According to the unanimous opinion, the claim that the safety of third parties ought to be taken into consideration is inapplicable in this case because the BFOQ defense concerns only the ability of an employee to perform a job in a safe manner, and a fetus, in this case, is not endangered by the manner in which the job is performed. "No one can disregard the possibility of injury to future children," the opinion states, but the BFOQ defense "is not so broad that it transforms this deep social concern into an essential aspect of batterymaking."

#### WRITING PROMPT

##### BFOQ-Sanctioned Discrimination

Why is the bona fide occupational qualification (BFOQ) exception a necessary provision of existing anti-discrimination law? Develop a case in favor of—and against—the Supreme Court's decision to reject Johnson Controls' BFOQ defense of its policy that excluded women from the manufacture of batteries.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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### 9.3.5: Remaining Issues

The decision in *Johnson Controls* clearly establishes that fetal protection policies constitute illegal sex discrimination, and the ruling is a victory for working women. It gives women the right not to have their job opportunities limited because of their ability to conceive and bear children. Still, two important issues remain. One is how to balance the rights of working women with the desirable social goal of protecting fetuses in the womb. The other is whether the right established in *Johnson Controls* conflicts with another desirable goal, namely, protecting corporations against liability in the event a person is harmed before birth from exposure to reproductive hazards in the workplace.

To what extent should women's job opportunities be limited in order to provide adequate fetal protection?

To what extent should corporations be held morally and legally responsible for protecting against reproductive hazards in the workplace?

The ruling in *Johnson Controls* does not leave the unborn without protection. In the words of the Court, "Decisions about the welfare of future children must be left to the parents who conceive, bear, support, and raise them rather than to the employers who hire those parents." There is little reason to believe that employees are any less concerned than employers about the well-being of their offspring. Indeed, they have a far more compelling interest. This is not to say that some parents-to-be (both men and women) will not choose work that exposes



them to reproductive hazards. However, they, rather than their employers, will be making the crucial decision about the reasonableness of that choice. Employees may decide—all things considered—that the risk is worth the price. Because parents in our society make choices in other matters that bear on the welfare of their children, such as where to live and how to educate them, why should an exception be made in the case of reproductive hazards? What is unfortunate is that some parents are forced to choose between making a living and protecting their children.

Whether the *Johnson Controls* ruling exposes corporations to heavy legal liability is an open question. The view expressed in the Court's opinion is that the prospect of being successfully sued for fetal harm is "remote at best," provided that employers

- fully inform employees of the risks they face, and
- do not act negligently.

If employees are to make rational choices in cases of exposure to reproductive hazards, then they must have sufficient information, which employers have an obligation to provide. Employers can further protect themselves from suits by cleaning up the workplace and, in other ways, reducing the risk as much as possible. In taking these steps, employers are still assuming significant responsibility for protecting workers from reproductive hazards.

## 9.4: Product Safety

### 9.4 Identify the responsibilities of manufacturers and consumers regarding harmful products, the ethical basis for three main theories defining these responsibilities, and problems with applying each theory

The right of consumers to be protected from harmful products raises innumerable problems for manufacturers. Many products can injure and even kill, especially if the products are used improperly.

- Every dangerous product can be made safer at some cost, but is there a limit to the safety improvements that a manufacturer ought to provide?
- Do manufacturers also have a responsibility to ensure that a product is safe before it is placed on the market?
- If a product, like the Firestone tire, is used on an automobile designed by another company, in this case Ford, who is responsible for ensuring safety? (See "The Ford-Firestone Brawl.")

Three theories are commonly used to determine when a product is defective and what is owed to the victims of accidents caused by defective products.<sup>52</sup> These are the due

care theory, the contractual theory, and the strict liability theory. Each of these theories appeals to a different ground for its ethical justification, and as legal doctrines, they each have a different source in the law.

### 9.4.1: Due Care Theory

Generally, manufacturers have an obligation to exercise *due care*, which means that they should take all reasonable precautions to ensure that products they put on the market are free of defects likely to cause harm. According to this due care theory, manufacturers are liable for damages only when they fail to carry out this obligation and so are at fault in some way. One ethical justification for this view is the Aristotelian principle of corrective justice: Something is owed by a person who inflicts a wrongful harm upon another. By failing to exercise due care, a manufacturer is acting wrongly and hence ought to pay compensation to anyone who is injured as a result.

The legal expression of this theory is the view in the law of torts that persons are liable for acts of negligence. Negligence is defined in the *Second Restatement of Torts* (Section 282) as "conduct which falls below the standard established by law for the protection of others against unreasonable risk of harm." The usual standard established by law is the care that a "reasonable person" would exercise in a given situation. Accordingly, a reckless driver is negligent (because a reasonable person would not drive recklessly), and the driver can be legally required to pay compensation to the victims of any accident caused by the negligent behavior.<sup>53</sup> In the case of persons with superior skill or knowledge, the standard is higher. A manufacturer can be assumed to know more than the average person about the product and, hence, can be legally required to exercise a greater degree of care.

**STANDARDS OF DUE CARE** The standards of due care for manufacturers or other persons involved in the sale of a product to a consumer, including wholesalers and retailers, cover a wide variety of activities. Among them are the following.

1. **Design.** The product ought to be designed in accord with government and industry standards to be safe under all foreseeable conditions, including possible misuse by the consumer. A toy with small parts that a child could choke on, for example, or a toy that could easily be broken by a child to reveal sharp edges is badly designed. Similarly, due care is not taken in the design of a crib or a playpen with slats or other openings in which a child's head could become wedged.
2. **Materials.** The materials specified in the design should also meet government and industry

standards and be of sufficient strength and durability to stand up under all reasonable use. Testing should be done to ensure that the materials withstand ordinary wear and tear and do not weaken with age, stress, extremes of temperature, or other forces. The wiring in an appliance is substandard, for example, if the insulation cracks or peels, posing a risk of electrical shock.

3. **Production.** Due care should be taken in fabricating parts to specifications and assembling them correctly, so that parts are not put in the wrong way or left out. Screws, rivets, welds, and other ways of fastening parts should be properly used, and so on. Defects due to faulty construction can be avoided, in part, by giving adequate training to employees and creating conditions that allow them to do their job properly. Fast assembly lines, for example, are an invitation to defects in workmanship.
4. **Quality Control.** Manufacturers should have a systematic program to inspect products between operations or at the end to ensure that they are of sufficient quality in both materials and construction. Inspections may be done either by trained personnel or by machines. In some programs every product is inspected, whereas in others inspection is done of samples taken at intervals. Records of all quality control inspections should be maintained, and the inspectors themselves should be evaluated for effectiveness.
5. **Packaging, Labeling, and Warnings.** The product should be packaged so as to avoid any damage in transit, and the packaging and handling of perishable foodstuffs, for example, should not create any new hazard. Also, the labels and any inserts should include instructions for correct use and adequate warnings in language easily understood by users.
6. **Notification.** Finally, the manufacturers of some products should have a system of notifying consumers of hazards that only become apparent later. Automobile manufacturers, for example, maintain lists of buyers, who can be notified of recalls by mail. Recalls, warnings, and other safety messages are often conveyed by paid notices in the media.

Use Table 9.1 to quiz yourself on the various standards manufacturers must meet in order to demonstrate that they are taking appropriate safety precautions. Identify the safety requirements for each task or aspect of manufacturing a consumer product. Hide the cells to quiz yourself and show them to check your answers.

One question that arises in the due care theory is whether manufacturers have an obligation to ensure that a product is safe to use as intended or to anticipate all the conditions under which injury could occur.

**Table 9.1** Standards of Due Care for Manufacturers

Task	Standards of Due Care
1. Design	<ul style="list-style-type: none"> <li>• Must meet government and industry standards</li> <li>• Should be safe under all foreseeable conditions</li> </ul>
2. Materials	<ul style="list-style-type: none"> <li>• Must meet government and industry standards</li> <li>• Should be strong and durable enough to stand up to reasonable use</li> </ul>
3. Production	<ul style="list-style-type: none"> <li>• Manufacturers must fabricate parts according to specifications.</li> <li>• All parts must be assembled correctly.</li> </ul>
4. Quality Control	<ul style="list-style-type: none"> <li>• Must have a systematic program to inspect finished products for quality materials and construction</li> <li>• Must keep records of all quality inspections</li> </ul>
5. Packaging, Labeling, and Warnings	<ul style="list-style-type: none"> <li>• Must package the product to avoid damage in transit</li> <li>• Packaging itself must be safe</li> <li>• Must provide warnings and clear directions for correct use</li> </ul>
6. Notification	<ul style="list-style-type: none"> <li>• Should have a system for notifying consumers of possible hazards</li> </ul>

### Do manufacturers have a duty to prevent all reasonably foreseeable harm?

The driver of a 1963 Chevrolet Corvair, for example, was severely injured in a head-on collision when the steering column struck him in the head. In the model of the car he was driving, the steering column was a rigid shaft that extended to the front end of the car. Although this design did not cause the accident, the victim claimed that his injuries were greater as a result of it. General Motors contended that its cars were intended to be used for driving on streets and highways and not for colliding with other objects. Consequently, it had no obligation to make them safe for this latter purpose. A U.S. court of appeals held, however, that due care includes “a duty to design the product so that it will fairly meet any emergency of use which can reasonably be anticipated.”<sup>54</sup>

This duty also extends to foreseeable misuse by the consumer. The owner’s manual for the 1976 Mercury Cougar, for example, explicitly stated that the original-equipment Goodyear tires should not be used “for continuous driving over 90 miles per hour.”<sup>55</sup> A U.S. court of appeals determined that the tread separation on the right-rear tire of a Cougar being driven in excess of 100 miles per hour was not the result of any flaw in the tire. However, the Ford Motor Company should have known that a car designed for high performance and marketed with an appeal to youthful drivers would occasionally be driven at speeds above the safe operating level of the tires. Accordingly, Ford should have warned owners of the Cougar more effectively or else equipped the car with better tires.

Some courts have held companies responsible not only for foreseeable misuse but also for misuse that is actively encouraged in the marketing of a product.<sup>56</sup> General Motors, for example, marketed the Pontiac Firebird Trans Am by entering specially reinforced models in racing competitions

and by featuring the car in crash scenes in “antihero scoff-law” motion pictures. A promotion film that had spliced together stunt scenes from these movies was used for promotions in dealers’ showrooms. In a suit brought on behalf of the driver of a 1978 Trans Am who was injured when the car went out of control while traveling more than 100 miles per hour, the court found for the plaintiff by invoking a doctrine of “invited misuse.”<sup>57</sup>

**ELEMENT OF NEGLIGENCE** The major difficulty with the due care theory is establishing what constitutes due care. Manufacturers have an obligation to take precautions that are more stringent than the “reasonable person” standard, but no means exist for determining exactly how far the obligation of manufacturers extends. The courts have developed a flexible standard derived from Justice Learned Hand’s famous formulation of the negligence rule.<sup>58</sup> In this rule, negligence involves the interplay of three factors:

1. the probability of harm,
2. the severity of the harm, and
3. the burden of protecting against the harm.

Thus, manufacturers have a greater obligation to protect consumers when injury in an accident is more likely to occur, when the injury is apt to be greater, and when the cost of avoiding injury is relatively minor. These are relevant factors in formulating a standard of due care, but they are not sufficient by themselves to decide every case.

Some standards for design, materials, inspection, packaging, and the like have evolved through long experience and are now incorporated into engineering practice and government regulations. However, these standards reflect the scientific knowledge and technology at a given time and fail to impose an obligation to guard against hazards that are discovered later.

**Example:** Asbestos companies claimed that the danger of asbestos exposure was not known until the 1960s, at which time they instituted changes to make handling asbestos safer. This so-called “state-of-the-art” defense—in which a company contends that it exercised due care as defined by the scientific knowledge and technology at the time—was flatly rejected by the New Jersey Supreme Court decision in *Bashada v. Johns-Manville Products Corp.* in 1982.<sup>59</sup> The court reasoned that Johns-Manville ought to have made a greater attempt to discover the hazards of asbestos. In the words of the court, “Fairness suggests that manufacturers not be excused from liability because their prior inadequate investment in safety rendered the hazards of their products unknowable.”

As a legal doctrine, the due care theory is difficult to apply. The focus of the theory is on the *conduct* of the manufacturer rather than on the *condition* of the product. So the mere fact that a product is defective is not sufficient for holding that a manufacturer has failed in an obligation of

due care; some knowledge is needed about specific acts that a manufacturer performed or failed to perform. Lawsuits based on the theory thus require proof of negligence, which the victims of accidents caused by defective products are often not able to provide. In addition, common law allows for two defenses under the due care theory: *contributory negligence* and *assumption of risk*. Just as a manufacturer has an obligation to act responsibly, so too does a consumer. Similarly, if consumers know the dangers posed by a product and use it anyway, then to some extent they assume responsibility for any injury that results.

## 9.4.2: Contractual Theory

A second theory is that the responsibility of manufacturers for harm resulting from defective products is that specified in a sales *contract*. The relation between buyer and seller is viewed in this theory as a contractual relation, which is subject to the terms of a contract. Even in the absence of an explicit, written contract, there may still be an implicit, understood contract between the two parties that is established by their behavior. This fact is recognized by the Uniform Commercial Code (UCC), Section 2-204(1), which states, “A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.”

**IMPLIED WARRANTIES** One of the usual understandings is that a product be of an acceptable level of quality and fit for the purpose for which it is ordinarily used. These implicit contractual provisions are part of what is described in Section 2-314 of the UCC as an *implied warranty of merchantability*. Manufacturers have both a moral and a legal obligation, therefore, by virtue of their contractual relation, to offer only products free from dangerous defects. A person who buys a new automobile, for example, is entitled to assume that it will perform as expected and that nothing in the design makes it especially hazardous in the event of an accident.

There is also an *implied warranty of fitness* for a particular purpose when the buyer is relying on the seller’s expertise in the selection of the product. In addition, an *express warranty* is created, according to Section 2-313 of the UCC, as follows:

Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise.

The notion of an affirmation is very broad and includes any description or illustration on a package or any model or demonstration of the product being used in a certain way.

**The ethical basis for the contractual theory is fairness in commercial dealings.** Agreements to buy or sell a product are fair only when they are entered into freely by the

contracting parties. Freedom in such agreements entails, among other things, that both buyers and sellers have adequate information about the product in question. Consumers know that the use of many products involves some danger, and they voluntarily assume the risk when the nature and extent of the hazards are revealed to them. Manufacturers may not take unfair advantage of consumers by exposing them to the risk of harm from hazards that are not disclosed. Selling a product that the manufacturer knows to be dangerous, without informing consumers, is a form of deception because crucial information is either suppressed or misrepresented. Even when the manufacturer is unaware of a defect, the cost of any accident caused by a defective product still ought to be borne by the manufacturer, because the product was sold with the understanding that it posed no hazards except those already revealed to consumers.

**PROBLEMS WITH WARRANTIES** One objection to the contractual theory is that the understandings in a sales agreement, which are the basis for implied and express warranties, are not very precise. Whether a product is of an acceptable level of quality or is fit for the purpose for which it is ordinarily used is an extremely vague standard. In practice, the theory leaves consumers with little protection, except for grossly defective products and products for which the manufacturer makes explicit claims that constitute express warranties.

Second, a sales agreement may consist of a written contract with language that sharply limits the right of an injured consumer to be compensated. If buyers and sellers are both free to contract on mutually agreeable terms, then the sales agreement can explicitly disclaim all warranties, express or implied. Section 2-316 of the UCC provides for the exclusion or modification of an implied warranty of merchantability as long as

1. the buyer's attention is drawn to the fact that no warranty is being given, with expressions such as "with all faults" or "as is";
2. the buyer has the opportunity to examine the goods; and
3. the defect is one that can be detected on examination.

If a consumer signs a contract with limiting language or explicit disclaimers, then, according to the contractual theory, the terms of that contract are binding. Both of these objections are illustrated in the classic court case in warranty law, *Henningsen v. Bloomfield Motors, Inc.*<sup>60</sup>

#### **Case: Henningsen v. Bloomfield Motors**

Claus Henningsen purchased a new 1955 Plymouth Plaza "6" Club Sedan for use by his wife, Helen. Ten days after taking delivery of the car from a Chrysler dealer in Bloomfield, New Jersey, Mrs. Henningsen was traveling around 20 miles per hour on a smooth road when she heard a loud noise under the hood and felt something crack. The steering wheel

spun in her hands as the car veered sharply to the right and crashed into a brick wall. Mrs. Henningsen was injured and the vehicle was declared a total wreck by the insurer. At the time of the accident, the odometer registered only 468 miles.

In the sales contract signed by Mr. Henningsen, the Chrysler Corporation offered to replace defective parts for 90 days after the sale or until the car had been driven 4,000 miles, whichever occurred first, "if the part is sent to the factory, transportation charges prepaid, and if examination discloses to its satisfaction that the part is defective." The contract further stipulated that the obligation of the manufacturer under this warranty is limited to the replacement of defective parts, which is "in lieu of all other warranties, expressed or implied, and all other obligations or liabilities on its part." By this language, liability for personal injuries was also excluded in the contract.

The question, as framed by the court, is simple:

In return for the delusive remedy of replacement of defective parts at the factory, the buyer is said to have accepted the exclusion of the maker's liability for personal injuries arising from the breach of warranty, and to have agreed to the elimination of any other express or implied warranty. An instinctively felt sense of justice cries out against such a sharp bargain. But does the doctrine that a person is bound by his signed agreement, in the absence of fraud, stand in the way of any relief?

The court's decision was that considerations of justice have greater force than an otherwise valid contract. Furthermore, the main conditions for a valid contract—namely, that the parties have roughly equal bargaining power and are able to determine the relevant facts for themselves—were absent in this case.

**First, there is a gross inequality of bargaining power between consumers and manufacturers.** Virtually all American cars at the time were sold using a standardized form written by the Automobile Manufacturers Association, which the dealer was prohibited from altering. Due to the lack of competition among manufacturers with respect to warranties, consumers had no choice but to buy a car on the manufacturer's terms—or else do without, which is not a genuine alternative in a society where an automobile is a necessity. Hence, consumers did not have freedom of choice in any significant sense, and manufacturers were not offering consumers what they truly wanted. Consumers would most likely prefer to buy cars with better warranties.

**Second, consumers are also at a profound disadvantage in their ability to examine an automobile and determine its fitness for use.** They are forced to rely, for the most part, on the expertise of the manufacturer and the dealer to ensure that a car is free of defects. Furthermore, the relevant paragraphs in the contract itself were among the hardest to read, and there was nothing in them to draw the reader's attention. "In fact," the court observed, "a studied and concentrated effort would have to be made to read them."

## WRITING PROMPT

### Product Warranties as Contracts

Think of the many different products that come with non-negotiable manufacturer warranties. Whose interests are warranties primarily designed to protect first—the manufacturers' or the consumers'? Why would you expect items that could potentially cause harm to actually have more robust warranties and additional exclusions?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 9.4.3: Strict Liability Theory

A third theory, now gaining wider acceptance in the courts, holds that manufacturers are responsible for all harm resulting from a dangerously defective product even when due care has been exercised and all contracts have been observed. In this view, which is known in law as *strict liability*, a manufacturer need not be negligent nor be bound by any implied or express warranty to have responsibility. The mere fact that a product is put into the hands of consumers in a defective condition that poses an unreasonable risk is sufficient for holding the manufacturer liable.

A more precise account of the theory of strict liability is given in Section 402A of the *Second Restatement of Torts* as follows:

1. One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if
  - a. the seller is engaged in the business of selling such a product, and
  - b. it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.
2. The rule stated in Subsection (1) applies although
  - a. the seller has exercised all possible care in the preparation and sale of his products, and
  - b. the user or consumer has not bought the product from or entered into any contractual relation with the seller.

**LEGAL ISSUES** The provision of 2(b) addresses an important legal issue in both the due care and the contractual theories. Generally, lawsuits under either theory have required that the victim of an accident be in a direct contractual relation with the manufacturer. This relation is known in law as *privity*. Suppose an accident is caused by a defective part that is sold to a manufacturer by a supplier, and the finished product is sold to a wholesaler, who sells it to a retailer. The consumer, under a requirement of *privity*, can sue only the retailer, who can sue the wholesaler, who in turn can sue the manufacturer, and so on.

The requirement of *privity* developed as a way of placing reasonable limits on liability, because the consequences of actions extend indefinitely. In a simpler age when goods were often bought directly from the maker, this rule made sense. With the advent of mass production, however, most goods pass through many hands on the way to the ultimate consumer, and the requirement of a direct contractual relation greatly restricts the ability of consumers to collect compensation from manufacturers. In the landmark case *MacPherson v. Buick Motor Company* (1916), the New York State Court of Appeals ruled that *privity* was not necessary when there is negligence.<sup>61</sup> Negligence was present, according to the decision, because the defect in the wooden wheel supplied by another manufacturer should have been detected during the assembly of the car.

The main blow to *privity* in the contractual theory came in *Baxter v. Ford Motor Company* (1934).<sup>62</sup> The Supreme Court of Washington State held that a driver who was injured by flying glass when a pebble struck the windshield had a right to compensation because all Ford cars were advertised as having Triplex shatterproof glass—"so made that it will not fly or shatter under the hardest impact." Because the truth of this claim could not easily be determined by an ordinary person, buyers have a right to rely on representations made by the Ford Motor Company. Hence, the wording of Ford's advertisements creates a warranty, in the view of the court, even without a direct contractual relation.

Strict liability as a legal doctrine did not make much headway in the courts until 1963, when the California State Supreme Court ruled in *Greenman v. Yuba Power Products*.<sup>63</sup> The relevant facts are that for Christmas 1955, Mr. Greenman's wife gave him a multipurpose power tool, called a Shopsmith, which could be used as a saw, a drill, and a lathe. Two years later, while using the machine as a lathe, the piece of wood he was turning flew out of the machine and struck him on the forehead. Expert witnesses testified that some of the screws used to hold parts of the machine together were too weak to withstand the vibration.

The court declined to consider whether Yuba Power Products was negligent in the design and construction of the Shopsmith or whether it breached any warranties, either express or implied. The only relevant consideration, according to the decision, was the fact that the tool was unsafe to use in the intended way. Specifically, the court held,

To establish the manufacturer's liability it was sufficient that the plaintiff proved that he was injured using the Shopsmith in a way it was intended to be used as a result of a defect in design and manufacture of which plaintiff was not aware that made the Shopsmith unsafe for its intended use.

Section 402A was formulated a year later in 1964. Since that time, all 50 states and the District of Columbia have

adopted the doctrine of strict liability as expressed in the *Second Restatement of Torts*.

The wording of Section 402A raises two questions of definition:

What is a “defective condition,” and what does it mean to say that a product is “unreasonably dangerous”?

Generally, a product is in a defective condition either when it is unsuitable for use as it is intended to be used or when there is some misuse that can reasonably be foreseen and steps are not taken to prevent it. A ladder that cannot withstand the weight of an ordinary user is an example of the first kind of defect; a ladder without a label warning the user against stepping too high is an example of the second. A defect in a product can include a wide range of problems—from poor design and manufacture to inadequate instructions or warnings.

The definition of “unreasonably dangerous,” offered in a comment on Section 402A, is,

The article sold must be dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics.

This definition is inadequate, however, because it implies that a product is not unreasonably dangerous if most consumers are fully aware of the risks it poses. All power lawnmowers are now required by federal law to be equipped with a “kill switch,” which stops the engine when the handle is released. Although the dangers of power mowers are obvious to any user, a machine without a “kill switch” is (arguably) unreasonably dangerous.

**ETHICAL ARGUMENTS** The ethical arguments for strict liability rest on the two distinct grounds of efficiency and equity.

- One argument is purely utilitarian and justifies strict liability for securing the greatest amount of protection for consumers at the lowest cost.
- The second argument is that strict liability is the fairest way of distributing the costs involved in the manufacture and use of products.

Both of these arguments recognize that there is a certain cost in attempting to prevent accidents and in dealing with the consequences of accidents that do occur. Preventing accidents requires that manufacturers expend greater resources on product safety. Consumers must also expend resources to avoid accidents by learning how to select safe products and how to use them correctly. Insofar as manufacturers avoid the cost of reducing accidents and turn out defective products, this cost is passed along to consumers who pay for the injuries that result. A manufacturer may save money, for example, by using a cheaper grade of steel in a hammer, but a user who suffers

the loss of an eye when the head chips ends up paying instead. When product safety is viewed as a matter of cost, the following two questions arise.

How can the total cost to both manufacturers and consumers be reduced to the lowest possible level?

How should the cost be distributed between manufacturers and consumers?

The efficiency argument holds, in the words of one advocate, that “responsibility be fixed wherever it will most effectively reduce the hazards to life and health inherent in defective products that reach the market.”<sup>64</sup> By this principle, manufacturers ought to bear this responsibility, because they possess greater expertise than consumers about all aspects of product safety. They also make most of the key decisions about how products are designed, constructed, inspected, and so on. By giving manufacturers a powerful incentive to use the advantages of their position to ensure that the products they turn out are free of dangerous defects, strict liability protects consumers at a relatively low cost. The alternatives, which include placing primary responsibility on government and consumers, generally involve comparatively higher costs.

The principle involved in the equity argument is expressed by Richard A. Epstein as follows: “[T]he defendant who captures the entire benefit of his own activities should . . . also bear its entire costs.”<sup>65</sup> Insofar as manufacturers are the beneficiaries of their profit-making activity, it is only fair, according to this principle, that they be forced to bear the cost—which includes the cost of the injuries to consumers as a result of defective products. Much of the benefit of a manufacturer’s activity is shared by consumers, however. But they also share the cost of compensating the victims of accidents through higher prices, and it is also just that they do so insofar as they reap some benefit. The distribution of the cost of compensating the victims of product-related injuries is fair, then, if this cost is distributed among all who benefit in the proportion that they benefit, so that it is not borne disproportionately by accident victims.

The major stumbling block to the acceptance of strict liability is that the theory ignores the element of fault, which is a fundamental condition for owing compensation on the Aristotelian conception of compensatory justice.<sup>66</sup> We all benefit from automotive travel, for example, but we can justly be required to pay only for accidents that are our fault. Any system of liability that makes us pay for the accidents of others is unjust—or so it seems. Similarly, it is unjust to hold manufacturers liable to pay large sums to people who are injured by defective products in the absence of negligence or a contractual obligation to compensate. It is equally unjust to force consumers to pay indirectly through higher prices the settlements in product liability suits.

### Why might it make sense for *everyone* to pay the costs for safety, regardless of who is at fault?

Some advocates of strict liability argue that it is not unjust to require those who are faultless to pay the cost of an activity *if everyone benefits by the use of an alternative method of paying compensation*. After all, the victims of accidents caused by defective products are not necessarily at fault either, and everyone is potentially a victim who deserves to be compensated for injuries received from defective products. Thus, those who “pay” under a system of strict liability are also protected. Furthermore, if manufacturers were not held strictly liable for the injuries caused by defective products, then they would take fewer precautions. As a result, consumers would have to spend more to protect themselves—by taking more care in the selection of products, by using them more carefully, and perhaps by taking out insurance policies—and to make up the losses they suffer in product-related accidents where no one is at fault. In either case, the lower prices that consumers pay for products under a negligence system based on the due care theory would not be sufficient to offset the higher cost of insurance, medical care, and so on.

Under a system of strict liability, consumers give up a right they have in the due care theory—namely, the right not to be forced to contribute to the compensation of accident victims when they (the consumers) are not at fault. Prices are also higher under a strict liability system in order to cover the cost of paying compensation. But consumers gain more than they lose by not being required to spend money protecting themselves and making up their own losses. They also acquire a new right: the right to be compensated for injuries from defective products without regard to fault. Thus, everyone is better off under a strict liability system than under a negligence system.

**ETHICAL OBJECTIONS** Critics reject many key assumptions in the two arguments for strict liability.

First, product liability covers many different kinds of accidents, and the most efficient or equitable system for one kind may not be efficient or equitable for another. Careful studies need to be made of the consequences of competing theories for each kind of accident. Some proposals for reform have recommended strict liability for defects in construction and a negligence system for design defects, for example.<sup>67</sup>

Second, the view that corporations are able to distribute the burden of strict liability to consumers effortlessly is not always true. Multimillion-dollar awards in product liability suits and the high cost of insurance premiums place a heavy burden on manufacturers, driving some out of business and hindering the ability of others to compete. Other complaints of critics are that the threat of liability

suits stifles innovation because new and untested products are more likely to be defective, and that a patchwork of state laws with differing theories and standards creates uncertainty for manufacturers. For these reasons, many business leaders have pressed for uniform product liability laws, upper limits on awards, restrictions on class-action lawsuits, and other steps to ease the impact of product liability on manufacturers.

### Which theory of product safety and liability ought to be adopted?

The theories rest on different ethical foundations. The due care theory is based on the Aristotelian principle of compensatory justice; the contractual theory, on freedom of contract; and strict liability, largely on utilitarian considerations. Each one embodies something we consider morally fundamental, and yet the three theories are ultimately incompatible. The contractual theory is the least satisfactory because of the power of manufacturers to write warranties and other agreements to their own advantage and to offer them to consumers on a “take it or leave it” basis. The main shortcoming of the due care theory is the difficulty of deciding what constitutes due care and whether it was exercised. Strict liability, despite the absence of fault, is arguably the best theory. It provides a powerful incentive for manufacturers to take great precautions and creates a workable legal framework for compensating consumers who are injured by defective products. For strict liability to be just, however, the costs have to be properly distributed, so that they are fair to all parties.

Table 9.2 summarizes the strict liability theory in regard to consumers.

**Table 9.2** Strict Liability and Consumers

Review the main elements of the strict liability theory and its impact on consumers. Hide the cells in the table to quiz yourself.

Strict Liability Theory	Description
<b>Premise</b>	Manufacturers should be held responsible for all harm resulting from a dangerously defective product, even when due care has been exercised and all contracts have been observed.
<b>Privity</b>	Privity does not apply. The manufacturer or seller is liable even if there is no direct or contractual relationship with the user or consumer.
<b>Pros for Consumers</b>	Consumers gain the right to be compensated for injuries from defective products without regard to fault.
<b>Cons for Consumers</b>	Consumers are forced to contribute to the compensation of accident victims by paying higher prices when they (the consumers) are not at fault.
<b>Barrier to Acceptance</b>	Everyone—manufacturers and consumers—pays the costs for safety, no matter who is at fault. This is arguably unjust to those who are blameless.

## Conclusion: Health and Safety

This chapter shows that workers and consumers have rights with regard to health and safety. Workers have a right to a safe and healthy workplace, and employers have a moral and, in many cases, a legal obligation to secure this right. In addition, consumers have a right to products that do not pose an unreasonable risk of injury, much less death, and manufacturers have a corresponding duty, both moral and legal, to provide safe products.

The controversial questions about these rights and duties concern two matters: What are the morally required levels of health and safety for workplaces and consumer products, and how can these levels best be achieved? Increasing the level of health and safety usually involves trade-offs with other goods, including lower prices for consumer goods, higher wages for employees, and greater profits for companies. The commonly accepted standard for making these trade-offs is cost-benefit analysis, in which the benefits of increased protection are balanced against the costs. In general, consumers, employees, businesses, and society at large are best served when cost-effective decisions are made.

The rights to know about and refuse hazardous work and the problem of reproductive hazards raise different issues about the extent to which employees should be involved in protecting themselves. Not only may a right to employee involvement in matters of health and safety be morally justified, but such involvement may also be an effective means for achieving workplace health and safety that complements the protections offered by employers.

### End-of-Chapter Case Studies

This chapter concludes with three case studies.

The following three case studies provide opportunities to explore issues that confront businesses in the areas of health and safety, both for employees and customers. The responsibility of employers to protect workers' health and safety has led, in some instances, to the adoption of corporate policies that, arguably, overreach and, perhaps unwittingly, infringe on another employee right. Specifically, these other rights are a right to privacy, which may be violated by genetic testing (Burlington Northern) and the right of women with regard to reproductive risk (Johnson Controls). In both of these cases, the policies adopted appear to have been designed less to protect employees and more to protect the companies' interests, which are also deserving of some protection. The Kolcraft crib case illustrates the complexity of factors that led an otherwise responsible company to market an unsafe consumer product, as well as the challenges that the company and other parties faced after the discovery of the defect.

## Case: Genetic Testing at Burlington Northern

Gary Avary, a 45-year-old track and maintenance worker for the Burlington Northern Santa Fe Railroad (BNSF), returned to work in October 2000 after successfully undergoing surgery for carpal tunnel syndrome (CTS).<sup>68</sup> A few days later the railroad's medical department requested all records of his treatment for CTS, and in December he was asked to report for a mandatory medical examination that would include blood tests. When his wife, a registered nurse, inquired about the need for blood, she inadvertently learned that a genetics test was included. Gary Avary was subsequently told that if he did not submit to the test, he would be fired.

The previous March, BNSF had introduced a policy of secret genetic testing of workers with CTS in order to determine whether any of them has a DNA defect known as Chromosome 17 deletion. This was thought to be associated with a condition called Hereditary Neuropathy with liability to Pressure Palsies (HNPP), which can make a person susceptible to nerve injuries, including CTS. HNPP is a rare condition that is estimated to occur in 1 in every 2,500 people.<sup>69</sup> Although approximately 90 percent of people with HNPP develop CTS, this defect can scarcely begin to account for the vast majority of CTS cases, especially among railroad workers whose lives have been spent in bone-jarring labor.

Gary Avary's union filed a suit, charging that BNSF had tested or had sought to test 36 employees who had filed claims for job-related CTS.<sup>70</sup> The suit was based on the Americans with Disabilities Act (ADA), which reads in part, "Medical examinations of existing employees must be job-related and consistent with business necessity." The company claimed, however, that the testing was a matter of business necessity. Injuries to railroad workers are subject to a 1908 law, the Federal Employers Liability Act (FELA), which allows jury trials. Because of the heavy potential liability, BNSF claimed that it has a right to defend itself, especially if the injury is due to genetic rather than workplace factors. In the words of the company's general counsel: "Any time an employee comes to us and says, 'I have an injury, and it's your fault,' we have a right to request and conduct the medical examination."<sup>71</sup>

Critics of BNSF's genetic testing discount this business necessity defense. First, the connection between Chromosome 17 deletion and CTS is not scientifically established and thus would probably not be admissible as evidence in any trial



under FELA. Second, according to critics, the real aim of the railroad was to discourage any injured employee from bringing a suit. An attorney for the union observed, “They show a guy a piece of paper that says, ‘This is your genetic test, and this condition wasn’t caused from your work,’ and they hope he will believe them.”<sup>72</sup> Many of the affected employees had no more than a seventh-grade education, and some did not speak English, making it more likely that they would accept the company’s claims.

Few employers will admit to genetic testing. A study conducted by the American Management Association in 2001 found only 2 among the 1,627 companies surveyed, although 16 percent said that they performed some medical tests to determine employees’ susceptibility to workplace hazards.<sup>73</sup> One company, Brush Wellman, which tested prospective employees for a genetic condition that increases the danger of exposure to beryllium, did not look at the results but gave them to the applicants so that they could decide for themselves whether to accept employment.<sup>74</sup> Although Brush Wellman thought that this was an innovative approach, critics question the value of this information if it is not based on valid science and if job applicants lack the ability to understand the risks. The result may be only unfounded fears.

In April 2001, Burlington Northern settled the suit by agreeing to halt genetic testing and to pay 36 employees \$2.2 million. The settlement short-circuited an opportunity for the courts to rule on whether genetic testing is prohibited by the ADA. Approximately half of the states have passed laws governing genetic testing, although their effectiveness is questionable. In 2008, President George W. Bush signed the Genetic Information Nondiscrimination Act, which regulates the use of genetic information by employers and health insurers.<sup>75</sup> Among the prohibitions, employers may not legally use individuals’ genetic information in making decisions about hiring, firing, job placement or promotion. As science and technology advance, though, the implementation of all such laws is sure to become more difficult.

### SHARED WRITING: GENETIC TESTING AT BURLINGTON NORTHERN

Explain whether or not “business necessity” could possibly justify Burlington Northern’s genetic testing of its railroad workers without their consent. Suppose the company had been open about the testing and obtained permission from its employees first. Try to defend the position that a greater susceptibility to a work-related illness or injury is a good reason for denying someone employment.

Review and comment on at least two classmates’ responses.

► **A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.**

Post

0 characters | 140 minimum

## Case: Johnson Controls, Inc.

Based in Milwaukee, Wisconsin, Johnson Controls was the largest manufacturer of automobile batteries for the U.S. replacement market.<sup>76</sup> Known chiefly for the production of control instruments for heating, lighting, and other electrical functions, Johnson Controls was also the largest independent supplier of automobile seating, and the company provided many small components for cars and light trucks. In 1978, Johnson Controls purchased Globe Union, Inc., a battery manufacturer. By 1990, the Globe Battery Division of Johnson Controls was operating 14 plants nationwide and employed approximately 5,400 people. Batteries accounted for roughly 18 percent of Johnson Controls’ sales and 17 percent of operating income.

Lead plates, which are essential for an automobile battery, are formed by compressing a paste of lead oxide. In this process, lead dust and lead vapor are released into the work area. Lead has been known for centuries to cause extensive neurological damage, and recent studies have shown that it affects the body’s cardiovascular system, leading to heart attacks and strokes. Children who are exposed to lead, through eating peeling lead-based paint, for example, exhibit hyperactivity, short attention span, and learning difficulties. Lead in a pregnant woman’s bloodstream can affect the neurological development of an unborn child, resulting in mental retardation, impaired motor control, and behavioral abnormalities. Pregnant women exposed to lead also run an increased risk of spontaneous abortion, miscarriage, and stillbirth. Although the effects of lead on men are less well understood, studies have shown some genetic damage to sperm that might cause birth defects.

Prior to Johnson Controls’ purchase of Globe Union, the battery manufacturer had instituted a comprehensive program to minimize lead exposure in the workplace and to keep employees from carrying lead home on their bodies and clothing. Although no legal standards for lead exposure existed at the time, Globe Union routinely tested employees’ blood lead levels and transferred employees with readings of 50 micrograms per deciliter ( $\mu\text{g}/\text{dl}$ ) of blood to other jobs without loss of pay until their levels had dropped to 30  $\mu\text{g}/\text{dl}$ . In 1978, the Occupational Safety and Health Administration (OSHA) set a permissible exposure limit for lead of 50  $\mu\text{g}/\text{dl}$ . OSHA did not establish a separate standard for pregnant women but recommended that both men and women who planned to conceive maintain blood levels below 30  $\mu\text{g}/\text{dl}$ . OSHA concluded that there is no reason to exclude women of childbearing age from jobs involving lead exposure.

In 1977, as more women began working in battery production, Globe Union informed women employees of the hazards of lead and asked them to sign a statement that

they had been told of the risks of having a child while exposed to lead in the workplace. Between 1979 and 1983, after Johnson Controls acquired Globe Union, eight women with blood lead levels in excess of 30 µg/dl became pregnant. In response, Johnson Controls changed its policy in 1982 to exclude fertile women from all jobs where lead is present. Specifically, the policy stated, “It is [Johnson Controls’] policy that women who are pregnant or who are capable of bearing children will not be placed into jobs involving lead exposure or which could expose them to lead through the exercise of job bidding, bumping, transfer or promotion rights.” The policy defined women “capable of bearing children” as “all women except those whose inability to bear children is medically documented.” In defending this policy, Johnson Controls maintained that a voluntary approach had failed and that to permit lead poisoning of unborn children was “morally reprehensible.” Undoubtedly, the company was also concerned with its legal liability.

In April 1984, a class-action suit was filed by several workers and their union, the United Auto Workers, charging that Johnson Controls’ fetal-protection policy violated the Title VII prohibition in the Civil Rights Act against sex discrimination. The policy is discriminatory, the employees complained, because it singled out fertile women for exclusion, when evidence indicates that lead also poses a hazard to the reproductive capacities of men. Although Title VII permits exceptions for bona fide occupational qualifications (BFOQs), the inability to bear children has no relevance to the job of making a battery and therefore cannot be a legitimate BFOQ. Johnson Controls’ fetal-protection policy applied to women who had no intention of becoming pregnant and those who might choose to accept the risk for the sake of keeping their jobs. The policy also offered women a choice of becoming sterile or losing their job, which some regarded as coercive. Among the employees suing were a woman who had chosen to be sterilized in order to keep her job, a 50-year-old divorcee who had been forced to accept a demotion because of the policy, and a man who had requested a leave of absence in order to reduce his blood lead level before becoming a father.

#### SHARED WRITING: JOHNSON CONTROLS, INC.

Many observers of the Johnson Controls case doubted whether the fetal protection policy was truly intended to protect the health of its female employees and their children. What are some reasons to support this doubt? What grounds were there for excluding female employees from the health risks posed by lead?

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: The Collapsing Crib

Executives at Chicago-based Kolcraft Enterprises became aware, in early February 1993, of two accidental deaths involving a discontinued product, the Travel-Lite crib.<sup>77</sup> An 11-month-old boy in California and a 9-month-old girl in Arkansas suffocated to death when the portable cribs in which they had been placed suddenly collapsed, trapping their necks in the “V” formed by the two halves of the folding unit’s top rails. News of these fatalities reached Sanfred Koltun, the CEO of the family-owned company and son of the founder, in a letter from the Consumer Products Safety Commission (CPSC). The letter, dated February 1, 1993, requested information from Kolcraft about the design and testing of the Travel-Lite crib as part of the commission’s responsibility to determine “whether a defect is present in a product and, if so, whether the defect rises to the level of a substantial risk of injury to children.”

### Developing the Crib

In the 1980s, the old fashioned playpen was reinvented as the portable play yard or traveling crib. This new product was typically square or rectangular in shape with a padded floor, mesh sides, and a tubular frame. The whole unit folded into a lightweight, easily assembled bundle, suitable for convenient transport. The innovative Kolcraft model had two hollow plastic sides with handles, which formed a carrying case when the floor and top rails were folded. When unfolded, the hinged top rails were held rigid by turning round plastic dial-like knobs located on the plastic end panels.

The accidents occurred when the mechanism securing the top rails failed, allowing the hinged tubes to fold downward. The collapsed rails created a V-shaped notch in which a child’s neck could become lodged, leading to suffocation. Such an accident is quite likely when a collapse is caused by a child leaning on the rails. One other infant death had occurred before the receipt of the CPSC letter, and afterward three more suffocation deaths resulted from collapses of the Travel-Lite crib. A total of six infant fatalities resulted from use of this one product.

Since its founding in 1942 from a producer of foam baby pads for playpens and high chairs, Kolcraft had grown into the manufacturer of mattresses, car seats, and other juvenile furniture products. The Travel-Lite crib was designed by an employee, Edward Johnson, who was a graduate of a technical high school with training in industrial draftsmanship. Hired by Kolcraft in 1979, he designed the company’s first car seat and was appointed head of engineering in 1989. In the spring of 1989, Johnson produced a painted-wood mock-up of a portable crib, which was well-received by Koltun and the company’s marketing department. Johnson said of the crib, which was his first

product of this kind, “It was unique because there was nothing out there with a carrying case.” A prototype model of the portable crib also created a favorable impression on buyers for the major retailers, including Sears, K-Mart, JC Penney, Walmart, and Target. Some buyers had difficulty operating the crib’s locking mechanism, and Johnson continued to make improvements to this feature until the buyers were satisfied. In June 1991, a patent was awarded for the easy-to-fold-and-carry Travel-Lite design.

Rapid development of the Travel-Lite crib was a high priority at Kolcraft in order to introduce the new product in mid-September at the annual Juvenile Products Manufacturers Association (JPMA) trade show, to be held in Dallas. The rush to get the product ready was rewarded by the favorable reception it received at the trade show, where the Travel-Lite crib was recognized as a winner in the “Ten Most Innovative Products Contest.” Further recognition was provided by a prominent mention in the “What’s New in Design” section of *Adweek* magazine.<sup>78</sup>

In order to market the company’s many juvenile products, Kolcraft entered into an agreement in the summer of 1989 with Hasbro, a Rhode Island-based multinational toy and game company, to license the company’s prominent Playskool brand name. At the last minute, the category of portable cribs was added to the licensing agreement, and consequently the new product was marketed as the Playskool Travel-Lite crib. Hasbro licensed the Playskool name for many products manufactured by other companies. For Hasbro, licensing its many brand names generated significant income from fees, while requiring little attention from the company.

In the licensing agreement, responsibility for testing products for legal compliance and certifying the results rested with the manufacturer, in this case Kolcraft. Although Hasbro operated its own quality assurance laboratory, it did not perform any tests of the Travel-Lite crib. When test results were requested by Hasbro to assure conformity with the provision in the agreement that “the licensed articles will be designed, produced, sold, and distributed in accordance with all applicable U.S. laws,” Kolcraft responded in a letter that there were no government standards applicable to the Travel-Lite crib. Hasbro accepted this assurance without hesitation or raising any objection. Kolcraft claimed the same lack of applicable government standards for portable cribs in a response to the request from the CPSC for testing-related information.

Despite the distinctive design, the Playskool name, and the crib’s availability in major retail chains, the Travel-Lite did not sell well. Between January 1990 and April 1992, only 11,660 units were sold to consumers. Kolcraft executives blamed the disappointing sales on the premium price of the Travel-Lite and its comparatively heavy weight. They found fault not with consumers but

with the retail buyers, who demanded improvements that increased the price and the weight and then stopped buying the expensive, heavy product after their demands were met.

## Kolcraft’s Response

When the CPSC letter arrived at Kolcraft, the Travel-Lite crib had been off store shelves more than a year. At that time, only three children were known to have died; of the remaining three known deaths, one occurred in 1995 and two in 1998. Although the sale of the crib was no longer at issue, children’s products of all kinds tend to be sold or given away, often exchanging hands multiple times.

In its response on February 12 to the CPSC, Kolcraft proposed sending a notice to retailers of the Playskool Travel-Lite crib in an effort to warn purchasers of the danger. The notice, accompanied by a poster with a picture of the product, urged parents to dispose of the crib and to call an 800-number for a \$60 refund. By June 1996, when the CPSC closed its file on the Travel-Lite crib, only 2,736 owners had responded to the offer.<sup>79</sup> A notice with a poster was subsequently sent to approximately 26,000 pediatricians, although the CPSC objected to the “many serious shortcomings” in the mailing, including the plain black-and-white format of the poster and the omission of the Playskool name. On February 19, the CPSC had made a preliminary determination that the crib posed “a substantial risk of injury to children,” which empowered the commission to seek some remedial action.

After repeated requests for testing records, Kolcraft finally responded on March 19, 1993, with a letter in which the company acknowledged that a number of government standards applied to portable cribs, including regulations on sharp points and edges, spacing and strength of components, flame resistance, and avoidance of holes that could entrap toes and fingers. The Travel-Lite crib met all of these standards. However, Kolcraft also claimed that its designers tested the folding mechanism to ensure that a child under eight years old could not exert the force required to dislodge the locking mechanism on the top rails. Although the company reported that a torque wrench showed that the necessary amount of force, 15 to 20 inch-pounds, greatly exceeded the government standard of 4 inch-pounds, Kolcraft was not able to produce records of such torque-force testing, which it conceded may have been done informally, without any recordkeeping.

On June 18, 1998, a suit was filed against Kolcraft and Hasbro by the parents of the fifth victim, who had died in a childcare facility in Chicago during naptime on May 18 of that year. The suit alleged not only that the crib was an unreasonably dangerous product but also that both companies had failed to conduct an adequate recall campaign.

That the cribs in which two children died were still being used in 1998, five years after the recall, showed the recall's ineffectiveness. Hasbro attempted to remove itself from the litigation, but the parents' suit argued that the company had assumed some responsibility by collecting fees for the use of the Playskool name.<sup>80</sup> Subsequently, the parents founded a nonprofit organization Kids in Danger to save lives by improving the safety of children's products.<sup>81</sup>

### SHARED WRITING: THE COLLAPSING CRIB

Where did the problem with the safety of the crib begin—with its design by an unqualified employee, the product design itself, or at a later point in the product's development? Explain whether or not it is morally right to hold Hasbro, in addition to Kolcraft, responsible for the deaths that followed.

Review and comment on at least two classmates' responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

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### Chapter 9 Quiz: Health and Safety

## Chapter 10

# Marketing and Advertising



## Learning Objectives

- 10.1** Explain how principles of fairness, freedom, and well-being are challenged by marketing practices and why an ethical framework is necessary
- 10.2** Analyze unethical sales practices, the difficulties sales personnel face in avoiding them, and issues with the sufficiency of information on product labels
- 10.3** Evaluate the nature and effects of unethical pricing and distribution practices on consumers and the fairness of markets
- 10.4** Identify the ethical issues with product development and market research and how companies can conduct these essential marketing tasks responsibly
- 10.5** Describe the difficulties in defining what constitutes deceptive advertising and how it interferes with consumers' ability to make rational choices
- 10.6** Recognize how different advertising practices use irrational persuasion techniques to influence consumers' choices and the ethical arguments against these practices
- 10.7** Assess the potential harm advertising poses to individuals and society and the responsibility of companies to consider the consequences of their marketing efforts
- 10.8** Examine how Internet advertising and the online collection and use of personal information challenge the rights of individuals to privacy, autonomy, and fair treatment
- 10.9** Summarize the significance of social advertising and the ethical issues associated with it

## Case: Selling Hope

In 1986, an outdoor billboard in a depressed community on the west side of Chicago offered hope. The message was, "Your way out." The promised ticket for these desperately poor people? The Illinois state lottery.<sup>1</sup> Although most lottery advertising is less blunt, the appeal of a life-changing event is a common theme. Although many consumer products are promoted as the fulfillment of people's deepest longings, state lotteries cruelly disappoint all but a few lucky winners. Still, as one New York state ad declared, "Hey, you never know."

Lotteries are a big business for the 44 states (plus the District of Columbia) that operate them.<sup>2</sup> In 2008, these games produced approximately \$52.8 billion in revenue, which, after an average payout of 61 percent, left more than \$18 billion, after expenses, for state coffers.<sup>3</sup> Among the expenses are approximately \$400 million that is spent on marketing, which

is necessary for the lotteries' success. As one lottery official explained, "To survive and prosper, it is essential that lotteries practice the business techniques of the private sector, particularly in the area of marketing."<sup>4</sup>

### Challenge of Marketing Lotteries

Lotteries present a marketing challenge. As a legal monopoly, they have no competitors, and so they cannot attract consumers away from competing brands, which is a major aim of much advertising. This leaves two objectives: recruiting new players and encouraging existing players to increase their activity.

### On which objective does most lottery advertising focus?

Lottery advertising focuses mainly on the latter, inducing confirmed gamblers to play more games and spend more money on each one. Marketing begins with the development of a product

mix because different games appeal to different groups. Marketers regularly develop new games with different features, such as the number and size of the payouts, the degree of complexity, and the length of time (from instant scratch cards and daily numbers to months-long, high-jackpot lotteries).

To aid them in product development and advertising, marketers use focus groups, telephone surveys, and other research tools to learn people's preferences and responses to proposed games. They also engage in target marketing by identifying specific demographic groups and learning which groups are more likely to participate in lotteries and what appeals to each one. Research shows that African Americans play more than Hispanics, and that non-Hispanic whites play less than either group; that men play more than women; that playing increases with age; and that playing correlates with lower education and income (with education a stronger factor than income).<sup>5</sup> In addition to the standard demographics of race, sex, age, and income, marketers also use lifestyle categories, such as Belongers, Achievers, Emulators, Socially Conscious, and so on. For example, Belongers are not ordinarily attracted to gambling but find lotteries acceptable because they are state sponsored. Their attitude is, "It's okay if the government says so." Belongers also like consistency and regularity and so are attracted to games that require repeated participation, like collecting letters to spell a word.<sup>6</sup>

## Criticism of Lottery Marketing

State sponsorship of lotteries is widely criticized, first, for being a regressive form of taxation that takes a disproportionate amount from those who can least afford to lose the money, and, second, for being an improper role for government. Although lottery revenue supports other state services, it is the only state activity that is not aimed directly at improving people's lives. Given that the objective of lottery commissions is to maximize revenues, it is understandable that they should engage in extensive advertising, and the amount spent is not out of line with consumer products companies in the private sector. However, lottery advertising is not regulated by the Federal Trade Commission, as is all private-sector advertising, and critics complain that ads for state lotteries could not meet federal standards.

Some of the criticism is directed at the social impact of advertising. Aside from enticing people to squander their limited income on lottery games instead of the basics of food, shelter, and the like (lottery ads are concentrated around paydays), lottery advertising promotes a get-rich-quick mentality that deters people, critics charge, from making investments in education and other ways of improving their life prospects. In a New York State television ad that was widely criticized, a mother was telling a daughter that she did not need to study so hard because Mom was playing the lottery, suggesting that luck could substitute for hard work.<sup>7</sup> Lottery advertising also relies heavily on fantasy. Some ads feature people who worry about how they will tell a boss that they are quitting and who

dream about owning the company they work for. Critics question whether encouraging such unrealistic aspirations is good public policy.

## What do you think is the main criticism of lottery advertising?

### Compare Your Thoughts

The main criticism of lottery advertising focuses on the question of deception. Although many ads highlight the maximum award, they seldom disclose the odds of winning it. In one Connecticut ad, the odds of winning any prize was correctly listed as 1 in 30, but the 1 in 13 million odds of winning the prominently displayed jackpot were nowhere to be found. Large jackpots are usually paid out over a 20-year period, and the present value of a multimillion-dollar prize may be barely half the face amount—and even less after taxes, which are not mentioned in the ads. Prizes may also be divided among several winners.

To counter awareness of the long odds, lottery advertising often includes profiles of winners and slogans like (from Arizona) "Every single second, someone is cashing a winning ticket." Psychological research shows that people's perceptions of probabilities are increased by tangible examples of successful outcomes.<sup>8</sup> Although some ads mention the good uses to which lottery revenue is put ("When Colorado plays, everyone wins"), such appeals may be deceptive because the benefits are usually so small. For example, the California lottery provides only 2 percent to 3 percent of school budgets, and even that amount is reduced if legislators use this source as a reason to cut other funding. Worse, the (false) idea that lottery revenues provide significant support may lead people to vote against increased taxes for education. In any event, advertising the social benefits of lottery revenue is not common because studies show that people do not respond to such appeals.<sup>9</sup>

Defenders of lotteries and lottery marketing argue that the poor are heavier users of games because they have more to gain, and that for this reason any restrictions would deprive them of life-changing opportunities. Winning the lottery, for some, may be the "way out" of poverty. Much of life depends on chance, so how are lotteries different from other factors in success? If more lottery outlets are located in poor areas, they are there to better serve the larger number of customers. A great deal of lottery advertising is merely instructional, explaining to people how to play the games, or else focused on the fun and excitement of playing. One study suggests that lottery advertising receives more attention from the more affluent, which, if true, would reduce the percentage of poor players but only by increasing the absolute numbers.<sup>10</sup> Although some people have gambling addictions, there is little evidence that lotteries severely impact the lives of typical players.<sup>11</sup> Finally, if lotteries are a regressive form of taxation, they are relatively painless and purely voluntary. Players apparently value the chance of winning and the excitement of the game, while the "tax" benefits everyone by supporting necessary state services. And "Hey, you never know."

## Points to Consider...

Since everyone is a consumer, marketing is an area of life where we all come into contact with businesses. The other main point of contact is the employment relation, which arguably raises more ethical issues, but only marketing affects everyone. Marketing is also an area where the conflict inherent in the marketplace is most acute. Marketers have strong incentives to sell products and services as well as powerful means for doing so. Despite the doctrine of *consumer sovereignty*—the notion that consumers are “kings” or “queens” in the economy because they ultimately decide whether to buy a company’s products—individual consumers are still vulnerable given the vast power of companies to determine what goods to offer and, through advertising, what consumers want. Because selling is so important for business and such powerful means are available, ethical problems are inevitable.

Marketing is an essential function in any business. As the marketing theorist Theodore Levitt observes, “There can be no effective corporate strategy that is not marketing oriented, that does not in the end follow this unyielding prescription: The purpose of business is to create and keep a customer.”<sup>12</sup> However, Levitt should add that businesses must also develop products and services that customers want at prices they are willing to pay. Marketing broadly conceived includes, then, making decisions about what products or services to put on the market, who are the potential customers for these goods, how to reach the target markets and induce them to buy, how to price the product or service to make it attractive to these customers, and how to deliver the goods physically to the ultimate consumers.

The part of marketing that involves inducing people to buy is achieved primarily by advertising. Advertising pervades our lives. It is impossible to read a newspaper or magazine, watch a television show or movie, or travel the streets of our cities without being bombarded by commercial messages. Although some ads may be irritating or offensive, the better efforts of Madison Avenue provide a certain amount of entertainment. We also derive benefit from information about products and from the boost that advertising gives to the economy as a whole. On the other side of the fence, companies with products or services to sell regard advertising as a valuable, indeed indispensable marketing tool. For more than a century, the portion of the gross national product devoted to advertising has been constantly between 1 percent and 2 percent.<sup>13</sup> So whether we like it or not, advertising is a large and essential part of the American way of doing business.

All of these matters are often expressed as the four Ps of marketing: product, price, promotion, and placement.

**What are the ethical decisions that marketing managers must make about each of these Ps?**

### Product, Price, Promotion, Placement

**Product.** Product, for example, raises obvious concerns about product safety, but the social impact of some products has drawn moral criticism. Aside from alcohol and tobacco, which are frequent targets of complaints, objections have been raised about unhealthful foods, gas-guzzling SUVs, and poor-value financial products aimed at the poor.

**Price.** Ethical issues about price include price gouging, predatory pricing (which undercuts the competition unfairly), price discrimination (charging more to some customers than others), misleading prices (for example, pricing that makes it difficult for consumers to make comparisons and markdowns from an unrealistic regular price), and price-fixing (colluding with competitors to keep prices high).

**Promotion.** Promotion is the most visible face of marketing, and for this reason it draws the greatest moral scrutiny. Much of the criticism of promotion focuses on questionable sales techniques and possible deception and manipulation in advertising. Many people are also concerned about the intrusiveness of direct marketing and the alleged social harm of some advertisements.

**Placement.** Finally, placement raises ethical issues about anticompetitive practices, such as controlling the channels of distribution, paying so-called slotting allowances for shelf space in stores, and so-called gray marketing, which is the diversion of goods outside officially sanctioned channels.

This chapter covers the four Ps—product, price, placement, and promotion—including advertising, which is part of promotion. The first three Ps are addressed by sections on sales practices, labeling, pricing, distribution, product development, and marketing research. The sections on advertising consider not only the central problem of deceptive advertising but also the ethical issues involved in using the powers of persuasion that advertisers possess, the personal social consequences of particular advertisements, and the development of advertising on the Internet. This chapter begins, though, with the development of a framework for marketing ethics.

## 10.1: Marketing Ethics Framework

### 10.1 Explain how principles of fairness, freedom, and well-being are challenged by marketing practices and why an ethical framework is necessary

Most of the ethical problems in marketing involve three ethical concepts: fairness, freedom, and well-being.

**Fairness** or justice is a central concern because it is a basic moral requirement of any market transaction—and the result of successful marketing is always a market transaction. In a market transaction, each party gives up something of value in return for something they value more. And such exchanges are fair or just (as well as mutually beneficial) as long as each party acts freely and has adequate information. The requirement of acting freely rules out exchanges in which there is coercion or manipulation or when one party lacks competence (children and other vulnerable populations, for example), and the adequate information requirement excludes the making of false, deceptive, or misleading statements (which may also be a kind of manipulation). These two requirements are often expressed as the absence of force and fraud.

### Why is the need for information problematic?

In a fair market transaction, a seller does not have an obligation to provide *all* relevant information to a buyer, and a buyer has some obligation to become informed about what is being bought. The question of who has the obligation to disclose or acquire what information leads to two traditional doctrines in marketing, namely, *caveat emptor* (let the buyer beware) and *caveat venditor* (let the seller beware). Under *caveat emptor*, the buyer has full responsibility to judge the quality of the goods absent any warranty or representation made by the seller. By contrast, the doctrine of *caveat venditor* places a responsibility on the seller to fully reveal the quality of the goods sold.

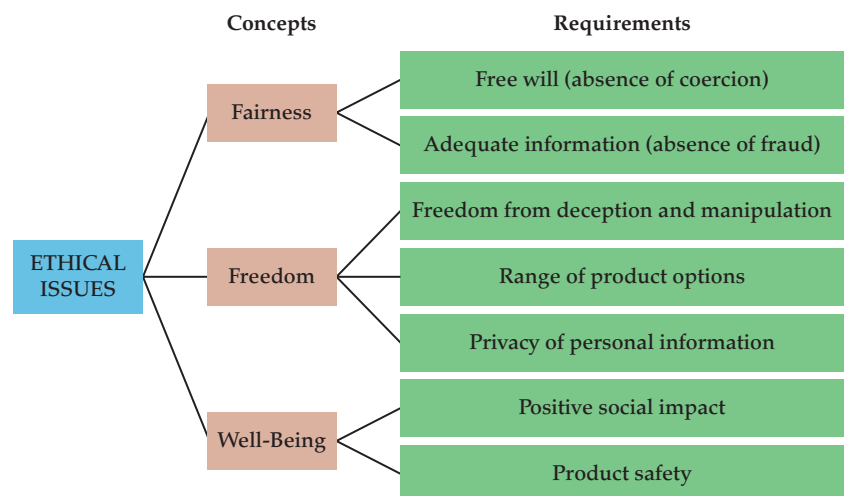
In practice, the responsibility for ensuring adequate information is divided between buyers and sellers. Buyers have good economic reasons to become informed (to protect themselves) and sellers, to provide information (to attract buyers). Beyond this division, the main principle is the cost—benefit calculation about which party can provide the information at the lowest cost. A great deal of consumer law assumes that because sellers can provide the necessary information more cheaply than consumers can acquire it, the responsibility rests largely with the sellers. To the questions of how much information to provide and of what kind, the guiding principle is the extent to which a lack of information is harmful to consumers. Generally, consumer laws require only the disclosure of information that buyers need to make rational purchasing decisions.

**Freedom** is at issue in marketing with respect to having a range of consumer options. As previously mentioned, freedom is denied when marketers engage in deceptive or manipulative practices and, in particular, take advantage

of vulnerable populations, such as children, the poor, and the elderly. In channels of distribution, large retailers, such as Walmart, have been accused of using their power to force small suppliers into accepting unfavorable agreements, and similarly large suppliers can take advantage of size to disadvantage small retailers. Freedom is also an issue in marketing research that invades the privacy of subjects against their will.

Finally, **well-being** is a consideration in evaluating the social impact of products and advertising, as well as product safety.

**Figure 10.1** Ethical Problems in Marketing



These three principles of fairness, freedom, and well-being can be expressed in the four-point bill of rights for consumers that President John F. Kennedy proclaimed in 1962, as a movement for consumer rights was developing in American society. These rights are as follows:

1. The right to be protected from harmful products (well-being).
2. The right to be provided with adequate information about products (fairness).
3. The right to be offered a choice that includes products that consumers truly want (well-being and freedom).
4. The right to have a voice in the making of major marketing decisions (freedom).

These rights are needed, according to consumer advocates, because the mere right not to buy (consumer sovereignty) provides inadequate opportunities for consumers to satisfy their needs and desires. Also, the burden of protecting their own interests is often too heavy for consumers to bear, especially in view of the unequal relation between buyers and sellers in present-day markets.

The first two of these rights are now embodied to some extent in federal consumer protection legislation and in the laws of many states.



**Examples:**

- The Consumer Product Safety Act (1972) created an independent regulatory body, the Consumer Product Safety Commission, which has the power to issue standards, require warnings, and even ban dangerous products entirely.
- The Fair Packaging and Labeling Act (1966) requires that containers disclose the ingredients of the product, the amount, and other pertinent information, including nutritional content in the case of food.
- The Magnuson-Moss Warranty Act (1975) specifies the information and the minimum conditions that must be included in a full warranty and requires that all warranties be written in comprehensible language.

In recent years, legal protection has been expanded in developing areas, most notably telecommunications and the financial services industry. The latter two rights, the rights to choice and a voice, have not been addressed by the law, due in part to the difficulty of formulating effective legal rules for such vague ideals. These rights remain unrealized—and perhaps unrealizable—goals of the consumer movement.

## 10.2: Sales Practices and Labeling

### 10.2 Analyze unethical sales practices, the difficulties sales personnel face in avoiding them, and issues with the sufficiency of information on product labels

Although companies rely on advertising to reach mass markets, most transactions are completed by personal selling. Most people experience personal selling as part of sales to individual customers (B2C marketing), but business-to-business selling (B2B marketing) also involves personal selling insofar as sales force members call on the people at other businesses who are responsible for buying. Labeling is also a major point of contact between businesses and their customers, since the information printed on products packaging is an important factor in purchasing decisions. A good label not only informs but also sells.

Sales personnel are typically put under great pressure to sell by such means as commissions, quotas, and other sales force management techniques. They may be led by this pressure to lie to customers, withhold information, make unrealistic promises, disparage the competition, and oversell (push products the customer does not need). Salespeople may also be tempted to cultivate customers with lavish entertainment or other perks and to close deals by offering or agreeing to pay kickbacks or outright bribes,

with or without the company's knowledge. Because sales people often work away from the office without close supervision, they have the opportunity to misrepresent their work, pad their expense accounts, or otherwise cheat their employers.

### 10.2.1: Deception and Manipulation

With respect to customers, the main moral obligation of a salesperson is to facilitate the conditions for a fair transaction, which are that the customer act freely and with adequate knowledge.<sup>14</sup> Although this duty can be violated in many ways, most of the attention given to unethical sales practices focuses on deception and manipulation.

Roughly, sales practices are deceptive when consumers are led to hold false beliefs about a product.<sup>15</sup> The most straightforward way to deceive, of course, is to lie by knowingly making a false statement, but one can also deceive without lying. For example, a piano salesperson may say that the "special sale" ends today but fail to add that another "special sale" will begin the next day and be repeated endlessly.<sup>16</sup>

#### Deception examples:

- Some common deceptions in sales are markdowns from a "suggested retail price" that is never charged, "introductory offers" that incorrectly purport to offer a savings, and bogus clearance sales in which inferior goods are brought in for the "sale."
- Packaging and labeling are deceptive when the size or shape of a container, a picture or description, and terms such as "economy size" and "new and improved" mislead consumers in some significant way.
- Warranties that cannot easily be understood by the average consumer may also be deceptive.

Manipulation is distinguished from deception in that it typically involves no false or misleading claims. Instead, it consists of taking advantage of consumer psychology to make a sale. More precisely, manipulation is noncoercively shaping the alternatives open to people or their perception of those alternatives so that they are effectively deprived of a choice.<sup>17</sup>

**Manipulation example:** "Bait and switch" is a generally illegal practice in which a customer is lured into a store by an advertisement for a low-cost item and then sold a higher-priced version. Often the low-cost item is not available, but even when it is, the advertised product may be of such low quality that customers are easily "switched" to a higher-quality, higher-priced product. Bait and switch is manipulative not only because consumers are tricked into entering the store but also because they enter in a frame of mind to buy.

Some groups of people are more vulnerable to manipulation than others, most notably children, the elderly, and the poor.<sup>18</sup> Special care needs to be taken, therefore, in marketing aimed at those groups.

Manipulation can also take place when salespeople use high-pressure tactics. A classic example of this kind of manipulation is the now-obsolete door-to-door encyclopedia salesman (they were all men in those days). The sales force of one encyclopedia company used deception to gain entry to the homes of prospects by claiming to be conducting advertising research (the questionnaires were thrown away afterward). Another company offered to place a set of encyclopedias “free,” provided the family bought a yearly supplement for a certain number of years at a price that exceeded the cost of the encyclopedia set alone.

### What kinds of high-pressure sales tactics are used today?

More recently, the office supply store Staples received notoriety for a system known as Market Basket, which recorded the dollar amount of accessories a salesperson managed to sell with each computer purchase.<sup>19</sup> An average of \$200 worth of additional sales, most notably in extra warranties, was reportedly expected from salespeople. One manager described the consequences of failing to meet this average as “not pretty.” Customers seeking to buy a computer described rude behavior from sales personnel, who would inform uncooperative customers that the computer sought was not in stock. In this practice, called “walking the customer,” a person left the store empty-handed. Although refusal to make a sale might seem to make no business sense, the additional revenue generated by the aggressive sales practices encouraged by Market Basket may have more than compensated for the lost sales.

The moral case against deceptive and manipulative marketing needs little explanation because it rests on the requirement that markets be free of force and fraud. The ethical questions in this area include difficulties in applying the rough definitions of deception and manipulation presented above.

## WRITING PROMPT

### Ethical Sales Practices

How much information is a seller obligated to provide to a customer in order to avoid deception? All selling involves the use of persuasive techniques, but when does good salesmanship cross over into manipulation?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 10.2.2: Information Disclosure

A separate but related problem in sales practices centers on the *kind* and *amount* of information that a salesperson should voluntarily disclose to a customer. Of course, customers would usually prefer that a sales agent disclose as much relevant information as possible about a product. The role of salespeople, however, is to vigorously promote certain products and ultimately to make a sale. Fulfilling this role effectively might require the salesperson to be selective in disclosing information about a product to a customer.

Selective disclosure of information does not necessarily involve deception or manipulation but may be morally objectionable nonetheless. Consider a situation where a salesperson neither makes false or misleading statements (which is deception) nor takes advantage of the psychology of the customer (which is manipulation). Suppose further that he or she does not withhold information about the product being sold but rather refrains merely from divulging relevant knowledge about a competitor’s product. Under these conditions, a case could be made that the customer is not being deceived or manipulated but has an interest in knowing about the competitor’s product.

Are there any ethical reasons why salespeople should tell customers about competing products?

The answer to this question depends upon an understanding of the salesperson’s role. In most situations, customers understand that a salesperson is an advocate for the product that he or she is selling.<sup>20</sup> Customers generally have no expectation that a salesperson will, or even should, provide *all* information relevant to purchasing a product. Full disclosure is not part of the salesperson’s role in the marketplace. The kind and amount of information that customers rightly expect salespeople to disclose, however, may vary depending upon what is being sold and the relative differences in knowledge between a salesperson and a customer.

Financial services, which are highly complex and could impact the long-term well-being of a customer, are examples of goods that might require greater disclosure in order for the customer to have adequate knowledge of the costs and benefits of the transaction. The same can be said for products that carry hidden risks of injury. The full disclosure of safety information may be part of the role of a salesperson because of the importance of customers’ basic health and safety. Consequently, information that, if concealed, could imperil a customer’s financial or bodily well-being arguably ought to be disclosed by a salesperson as a matter of right.<sup>21</sup>

Other information that may be needed to make a well-informed judgment about a product includes facts that a customer cannot reasonably be expected to know without the assistance of a salesperson.<sup>22</sup> Thus, sales personnel

have a responsibility to disclose certain information that customers cannot obtain on their own that is relevant to good decision making about the purchase of a product. Real estate agents who sell homes, for example, are expected to disclose any information they have about a home's significant defects prior to the completion of a sale. In cases when hidden defects are known by the seller but cannot be easily known by a buyer, a moral duty of disclosure falls on the better informed party. Again, what is not easily known by a customer and what information is needed to make a well-informed judgment will vary according to the importance of the information and the costs and benefits of disclosure.

Ultimately, the kind and amount of information that a sales agent is morally obligated to disclose is based on judgments about what information a customer could reasonably be expected to know and would require before purchasing a product in a fair transaction. These are difficult judgments to make, but fairness requires more than simply providing the information that a customer actually requests or expects.<sup>23</sup> Fairness requires that salespersons disclose the information that a reasonable customer would need to make an informed decision given his or her limited knowledge and capability.

### 10.2.3: Labeling

Many purchases occur without any contact with a salesperson. When a consumer merely takes a product off a shelf, the main contact between that individual and the manufacturer is the print on the package. The label becomes a means not only for selling a product but also for informing the public. What appears on a label is important, therefore, in judging the fairness of the transaction.

**LABELS AS INFORMATION** Consider the plight of a consumer examining a frozen apple pie in a sealed, opaque cardboard box. Without information on the label, consumers have no practical means for determining the size of the frozen pie, the ingredients used, the nutritional content, or the length of time the product has been sitting in the freezer case. Health-conscious consumers are especially disadvantaged by the welter of claims about low fat and salt content and the unregulated use of words such as "light" and "healthy." Certainly, the more information consumers have, the better they can protect themselves in the marketplace. The ethical question, though, has two aspects:

How much information is a manufacturer obligated to provide?

To what extent are consumers responsible for informing themselves about the products for sale?

**The Fair Packaging and Labeling Act** was passed by Congress in 1966 to enable consumers to make meaningful value comparisons. Specifically, the Act requires that each

package list the identity of the product; the name and location of the manufacturer, packer, or distributor; the net quantity; and, as appropriate, the number of servings, applications, and so on. There are detailed requirements for many specific kinds of products in the Fair Packaging and Labeling Act and other statutes. The rationale for this legislation is that certain information is important for making an informed consumer choice, and consumers have few means for securing the information if it is not provided by the manufacturer. Moreover, the manufacturer already possesses this information and can provide it to all consumers in one easy step.

**The Nutrition Labeling and Education Act (NLEA)** of 1990 further requires that the labels on packaged food products contain information about certain ingredients, expressed by weight and as a percentage of the recommended daily diet in a standardized serving size. The total number of calories and the number of calories from fat must also be listed along with the percentage of the recommended daily intake of certain vitamins and minerals. In addition, the NLEA lists the health claims that are permissible and defines such terms as "low fat," "light," and "healthy." Previously, food manufacturers were able to manipulate the information on labels. The amount of fat or salt could be reduced, for example, merely by decreasing the listed serving size. A product labeled "light," which was previously undefined, could contain a substantial amount of fat.

Manufacturers offer a number of reasons for not providing more information. A detailed listing of amounts of ingredients might jeopardize recipes that are trade secrets; listing the kind of fat would prevent them from switching ingredients to take advantage of changes in the relative prices of different oils; product dating is often misunderstood by consumers, who reject older products that are still good; and packaging has to be designed with many considerations in mind, such as ease in filling, the protection of goods in transit, the prevention of spoilage, and so on. Therefore, the objectives of the Fair Packaging and Labeling Act and the NLEA, manufacturers argue, need to be balanced against a number of practical constraints. Still, the bottom line is that consumers should have sufficient information to make rational buying decisions.

**INFORMATION ABOUT GMOs** But what is sufficient information from a consumer's point of view? Consider recent lobbying efforts by environmental groups in favor of laws requiring food manufacturers to indicate the presence of genetically modified organisms (GMOs) on labels. GMOs are non-naturally occurring plants or animals whose genetic composition has been altered through the use of recombinant DNA technology. This technology has allowed scientists to alter the genetic composition of grains to tolerate certain pesticides or to contain more nutrients.

Both developments increase crop yields and ultimately benefit both producers and consumers.

Advocates of GMO labeling laws argue that companies should be required to state whether their products contain GMOs because the health and environmental impacts of large-scale GMO production and use are still unknown. They argue further that such labeling is necessary to respect consumers' right to know about ingredients that may impact their health and the environment.<sup>24</sup> Producers and regulators are concerned, however, that consumer resistance to GMOs is without foundations and that labeling GMO content could give rise to unnecessary fears that could reduce the benefits of genuine technological advances in agriculture. Critics of GMO labeling are also wary of a patchwork of laws with different labeling requirements that can create unclear guidelines for companies that sell food nationally and even globally. They point, further, to the difficulty and costs associated with tracking GMO ingredients in the food supply.<sup>25</sup>

At the heart of this issue, however, is whether consumers are entitled to GMO-related information even when the science about the adverse health and environmental impacts of GMOs remains in dispute.<sup>26</sup> Some observers have argued that there is a difference between a consumer's *right* to know certain things about the products they purchase and their *interest* in knowing those things.<sup>27</sup> It may be that many consumers have an interest in knowing which foods have GMOs because of their individual beliefs about GMOs. This interest does not necessarily entail a right to have that information provided to them.

A right is entailed when the interest of consumers is sufficiently compelling to satisfy the three key factors of fairness, freedom, and well-being.

## 10.3: Pricing and Distribution

### 10.3 Evaluate the nature and effects of unethical pricing and distribution practices on consumers and the fairness of markets

Pricing and distribution are critical for efficient markets. The price of any good should reflect all available information about its value and thus enable market participants to make rational economic choices. Generally, inaccurate prices—which are prices that do not reflect the value of the goods in question—distort economic decision making. Price supports for agricultural products, for example, lead to overproduction and consequently to uneconomic consumption of resources. There are strong economic reasons, therefore, to ensure that the prices of all goods accurately reflect their value. Distribution, which is the process of delivering goods to consumers, contributes to efficiency by

reducing the costs of such delivery to the maximum feasible extent. The concern of ethics with distribution arises when methods of distributing goods are used that enable businesses to benefit at the expense of consumers, or sometimes enable one company to gain an unfair advantage over another.

The moral (and legal) issues in pricing fall into two categories.

- The first category involves the use of prices to engage in anticompetitive behavior that can seriously harm other firms. The prevention of such anticompetitive behavior is the subject of antitrust law, which seeks to ensure low, accurate prices by preventing monopolies. When a single company (a monopoly) or a few companies (an oligopoly) dominate a market, the lack of competitors allows such firms to charge artificially high prices.
- The second category concerns fairness in pricing, which can be violated when prices are used to deceive or manipulate consumers and when goods are overpriced in ways that consumers cannot easily detect.

### 10.3.1: Anticompetitive Pricing

Most anticompetitive marketing practices are illegal under the following acts:

- the Sherman Act (1890)
- the Clayton Act (1914)
- the Federal Trade Commission Act (1914)
- the Robinson–Patman Act (1936)

Many states also have antitrust statutes that prohibit the same practices. The major anticompetitive marketing practices prohibited by these acts are price-fixing, resale price maintenance, price discrimination, and predatory pricing.

1. **Price-Fixing.** Price-fixing is an agreement, either explicit or implicit, among two or more companies operating in the same market to sell goods at a set price. Such an agreement is contrary to the usual practice whereby prices are set in a free market by arm's-length transactions. The effect of price-fixing, obviously, is to raise prices above what they would be in a free market. Most commonly, price-fixing is horizontal, among different sellers at the same level of distribution, but price-fixing can also be vertical, when it occurs between buyers and sellers at different levels, such as an agreement between a manufacturer and a wholesaler. Price-fixing occurs not only when there is an explicit or implicit agreement among competitors to charge similar prices, but also when the same result is achieved by other means.

## Examples

Other methods of fixing prices include

- an implicit agreement to follow an industry standard (parallel pricing) or the lead of a dominant seller (price leadership);
  - a situation in which one company effectively controls the prices of competitors (administered price); and
  - market allocation, in which competitors agree not to compete in certain geographical areas or with certain buyers.
2. **Resale Price Maintenance.** This is a practice whereby products are sold on the condition that they be resold at a price fixed by the manufacturer or distributor. Resale price maintenance is thus a form of vertical price-fixing as described earlier. There are various reasons for imposing resale price maintenance on retailers, including fostering a prestige image, enabling a larger number of retailers to carry a product, and providing an adequate margin for promotion or service. As a form of price-fixing, resale price maintenance prevents prices from being set by the forces of a competitive market.
  3. **Price Discrimination.** Sellers engage in price discrimination when they charge different prices or offer different terms of sale for goods of the same kind to different buyers. Often this occurs when buyers are located in different geographical regions or vary in size or proximity to other sellers. Thus, a seller who gives a discount to large buyers solely by virtue of their size is guilty of discriminating against small buyers. However, bulk discounts and other price differences are legal as long as the same terms are available to all buyers or if they are good-faith attempts to meet competition in particular markets or legitimately reflect the higher

costs of doing business. Price discrimination can be practiced not only by sellers but also by large buyers. The Robinson–Patman Act prevents large buyers, such as chain stores, from demanding and receiving preferential treatment from manufacturers and wholesalers to the detriment of smaller buyers.

4. **Predatory Pricing.** Predatory pricing consists of reducing prices to unreasonably low or unprofitable levels in order to drive competitors out of business. Once this occurs, the company is in a monopoly position and can recoup its losses by charging much higher rates. The key factors are intent and consequences: whether low prices are offered with a view to raising prices later and whether prices, in fact, do rise later. Walmart, for example, does aim to drive competitors out of business, but not so that Walmart can raise prices, which remain low even where its stores are in a monopoly position. Walmart's low prices are precisely what healthy competition is supposed to achieve.

### Why is predatory pricing often difficult to prove?

There are several reasons.

- First, a company like Walmart with a low-cost structure might be able to make a profit selling goods at prices that would be unprofitable for competitors.
- Second, a company might sell goods at a loss in order to reduce inventory that otherwise would not be sold at all. Department store clearance sales are often of this character.
- Third, some companies may sell at a loss in order to gain market share and become competitive. Some computer software is distributed free for this reason.

Use Table 10.1 to review these four anticompetitive pricing practices and consider their impact.

**Table 10.1** Anticompetitive Pricing Practices

Hide the cells in the table to test your knowledge of each practice and its effect, or why it is anticompetitive. Show the cells to check your answers.

	What is it?	What is the effect?
<b>Anticompetitive Pricing Practices</b>	Any pricing practice that uses low levels of competition to raise prices or reduce quality	A monopoly (or oligopoly) that can charge higher prices or offer lower quality than in a fair, competitive market
<b>1. Price-Fixing</b>	Two or more companies sell goods at a set, higher price, with or without an explicit or implicit agreement	Rival goods and companies can be driven out of the market, reducing supply and consumer choice.
<b>2. Resale Price Maintenance</b>	Products are sold on the condition that they be resold at a price set by the manufacturer or distributor.	Retailers put more effort into promotion and services; products gain prestige from artificially higher prices.
<b>3. Price Discrimination</b>	Sellers give preferential treatment by charging different prices for the same goods to different buyers. The preferential treatment is not based on the costs of doing business.	Same as price-fixing; consumers must shop at preferred retailers or deal with limited choices and higher prices elsewhere.
<b>4. Predatory Pricing</b>	Prices are reduced to unreasonably low or unprofitable levels to drive competitors out of business and then charge much higher rates.	Same as price-fixing; discourages new or other companies from entering the market.

## WRITING PROMPT

### Comparing Anticompetitive Pricing Practices

Competition to increase one's market share is natural in the pursuit of businesses. Explain whether any of the discussed pricing practices seem, at first glance, like a reasonable strategy for an ambitious company. In your opinion, which is the least defensible?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 10.3.2: Unfair Pricing

Pricing can be done in ways that treat consumers unfairly. The main types of such unfair pricing are unconscionably high prices (price gouging) and misleading prices, including prices that are difficult to determine and compare.

**PRICE GOUGING** The adage “charge what the market will bear” is good advice under ordinary market conditions but not in all circumstances. For one, temporary shortages of critical goods, such as occur during natural disasters, create opportunities for charging very high prices. Oil companies have been accused of price gouging during periods of shortage, which are sometimes due to war, and airline prices during peak periods are similarly criticized. Charges of price gouging have also been leveled against pharmaceutical companies, especially in the pricing of AIDS drugs, and against lenders who prey on the poor by charging exorbitant rates of interest and piling on high fees. So-called payday loans, for example, can carry annual interest rates above 500 percent, and interest combined with late fees and other charges have resulted in some people owing more than 10 times the original loan amount.<sup>28</sup>

In the absence of shortages, it is difficult for companies to sell overpriced products to well-informed consumers with ample choices. However, there are some products that are difficult to evaluate and that people can be persuaded to buy. Unless force or fraud is employed, the sale of these products is generally legal, but consumer advocates still object that they are overpriced. Examples include highly profitable extended warranties for appliances and collision damage waivers for rental cars (which are sometimes pushed on renters with high-pressure tactics).

Psychological research shows that people make nuanced judgments about when it is fair to raise prices.<sup>29</sup> Taking advantage of natural disasters is generally regarded as unfair. Tickets to sports events could vary according to the expected demand, but teams do not do this for fear that charging high prices for popular games would be viewed as taking unfair advantage, even though people willingly pay a premium to scalpers without feeling cheated. Airlines

seek to counter the perception that charging full last-minute rates to travelers attending family funerals is unfair by offering special bereavement rates. These examples show that, to some extent, people's perceptions of fairness in pricing affect companies' pricing behavior.

**MISLEADING PRICES** Misleading prices are a form of deception in which customers are induced to buy because they believe the good is a bargain. Perhaps the most common form of misleading prices is selling goods at prices reduced from a supposed regular price or the manufacturer's suggested retail price (MSRP). In order to get around state laws, some stores offer goods at full price for a short period of time before reducing them to “sale” prices for the rest of the selling season. A markdown from an MSRP that is never charged also creates a false impression of savings. The main principle used by the courts in determining whether such “high-low” pricing is deceptive is the extent to which the seller makes a good-faith attempt to sell at full or MSRP price.

When customers are accustomed to paying a certain price for a product, such as a candy bar, manufacturers often reduce the size in order to maintain the same price, a practice known as *customary pricing*.

**Example:** The size of one popular brand of tuna was reduced without any fanfare from the industry standard of 6½ ounces to 6¼ ounces. Although the same price was maintained per can, this constituted a nearly invisible 5.8 percent price increase for the tuna.<sup>30</sup>

The proliferation of products at different quantities and prices makes it difficult for consumers to compare even those from the same manufacturer. For example, mattress manufacturers produce constantly shifting lines at different prices so that price comparisons between lines and mattresses from other manufacturers are virtually impossible to make. It is generally difficult for consumers to compare packaged-food items to determine how much they cost per ounce or other measure.

For this reason, some municipalities and states require *unit pricing*, in which the cost of packaged food in some standardized unit is displayed on the shelf. To ensure that consumers are aware of the price of goods, there are laws in some parts of the country that require prices to be displayed on each item (item marking) and not merely on the shelf.

**Example:** Mobile phone companies are under consistent scrutiny because the prices they offer for data charges are difficult to decipher. Competitors in this industry do not offer easily comparable data units and different companies offer varied, discounted prices for multiple phone numbers on the same account. This prevents a clear understanding of a service provider's price per unit of data.<sup>31</sup>

In addition, some products have hidden costs.

- The price of tires often excludes mounting, balancing, extended warranties, and other extras, which are often mentioned to consumers after a decision has been made to buy (a sales technique known as “low-balling”).
- Consumers cannot compare two air conditioners without knowing the cost of operating them, because a cheaper but less-efficient air conditioner can cost more in the long run. Manufacturers of household electrical appliances are now required by law, therefore, to disclose the amount of energy used in a year and the range of energy consumption for products of the same kind.

Comparisons are facilitated by standard units for measuring the relevant factors. Thus, tires are required by federal law to be graded with a tread-wear index and a rating for traction, and insulating materials have an R-value that enables consumers to compare different grades of insulation. All of these requirements enable consumers to make sense of prices and make rational consumer choices.

### 10.3.3: Distribution

Distribution, which is the means by which products are delivered from the manufacturer to the ultimate consumer, is a necessary function of marketing that is of increasing importance. Once regarded merely as a matter of logistics, distribution is now a source of competitive advantage as large retailers seek to cut costs in the distribution chain and manufacturers find means of doing so. In the process, distribution relations have become more complex and competitive, thereby increasing the number of ethical problems.

The main ethical issues in distribution are

- anticompetitive practices,
- slotting allowances to gain access to shelf space in stores, and
- gray markets that arise from diverting and parallel importing.<sup>32</sup>

Another problem area in distribution is *direct marketing*, which is not considered here because the main ethical concern is the violation of privacy through the use of databases of personal information.

**ANTICOMPETITIVE PRACTICES** Whenever manufacturers have greater power than retailers or vice versa, the stronger party can use its power to force agreements that the other party would not otherwise make. Such use of market power to determine which products are made available to consumers and what prices are charged

constitutes anticompetitive practices, many of which are prohibited by law. Three specific illegal abuses of power in distribution are reciprocal dealing, exclusive dealing, and tying arrangements.

*Reciprocal dealing* involves a sale in which the seller is required to buy something in return, as when an office supply firm agrees to buy a computer system only on the condition that the computer firm agrees to purchase supplies from the office supply firm. In an *exclusive dealing* agreement, a seller provides a product—a brand of sportswear, for example—on the condition that the buyer not handle competing brands. These practices are anticompetitive because they force transactions that do not make economic sense (otherwise the transactions would be freely made).

A *tying arrangement* exists when one product is sold on the condition that the buyer purchases another product as well. An example of a tying arrangement is an automotive supply firm that requires as a condition for selling tires to a service station that the buyer also purchase batteries from the seller. A kind of tying arrangement but one that is generally legal is *full-line forcing*, in which a retailer is forced to carry a manufacturer’s full line of products as a condition for carrying any product from that manufacturer. Full-line forcing is ethically questionable because it freezes out other manufacturers when a retailer can reasonably carry only one or a few lines, and it limits consumer choice at any given retailer. Manufacturers often employ this practice to take advantage of the popularity of a few products and to secure outlets for products with a higher margin.

**SLOTting ALLOWANCES** One of the most controversial practices in distribution is the payment of *slotting allowances*, which are payments by manufacturers to retailers to secure space on store shelves. Carried to an extreme, this practice makes store shelves a kind of real estate that retailers lease to the highest bidder. Manufacturers have been shifting resources from advertising to trade promotions of various kinds in part because large retailers increasingly have the power to demand such payments. However, another reason for favoring trade promotions over advertising is that hurried consumers are more likely to buy a product because it is conveniently displayed, and hence easy to buy, than because it has been heavily advertised.

Some critics of slotting allowances regard the practice as a kind of shakedown of manufacturers, made possible by retailers’ increasing power. In addition, the fees, which can total tens of thousands of dollars, prevent smaller manufacturers from getting stock on retailers’ shelves, and the added savings to retailers are not always passed along to consumers, who may end up paying higher prices.

Retailers argue in reply that the fees cover the added costs of purchasing, stocking, and labeling, especially of new products, and provide a means for manufacturers to get new products to market quickly. Although slotting allowances are currently legal, Congress and state legislatures are looking into the matter, and the reluctance of people in the industry to discuss the practice suggests that it is ethically questionable. In some unusual cases, slotting allowances, or similar arrangements, have been offered by manufacturers as a way to preserve the strength of certain large retailers that have historically favored the manufacturer's interests (this is discussed in the McCormick's Pricing Strategy case).

**GRAY MARKETS** Gray markets result when products are sold outside the channels of distribution authorized by a manufacturer. This may be due to *diverting*, which occurs when a wholesaler sells goods to unauthorized intermediaries who in turn sell them to unauthorized retailers in the same market area. Another cause of gray markets is *parallel importing*, in which goods intended for one market (say Asia) are distributed without authorization in another market (say Europe). In both cases, a company may find that the products sold through authorized channels are competing with the same products sold in a gray market, almost always at a lower price. The lower price of gray market goods is possible because authorized channels include extra costs, such as creating and maintaining a reliable distribution system and providing after-sale support service, which are avoided by diverting or parallel importing. Although the buyers in a gray market may enjoy a savings on the purchased goods, they may lack the warranty protection and after-sale service that are provided when the same goods are sold by an authorized retailer.

Gray markets have several undesirable effects.

- First, they make it more difficult for manufacturers to maintain channels of distribution with reliable and responsible distributors.
- Second, they force manufacturers to unbundle warranties and after-sale service, which deprives consumers of these benefits as well as the manufacturers, for whom these are often profitable items.
- Third, gray markets create consumer dissatisfaction and erode brand value when buyers of gray market goods blame the company for lack of warranty and after-sale service.

On the other hand, gray markets drive down prices, and for mass-market goods that do not require the benefits of authorized channels of distribution, this may be in the consumers' and ultimately the manufacturers' interest. To some extent, gray markets serve to wring excess costs out of distribution systems.

## 10.4: Development and Research

### 10.4 Identify the ethical issues with product development and market research and how companies can conduct these essential marketing tasks responsibly

Successful marketing depends upon having reliable knowledge about all aspects of the marketing environment, ranging from opportunities for new products to more general considerations about market trends and marketing methods. New product development is critical for growth as consumers often tire of old products while competitors are busy imitating those that succeed. For example, McDonald's, which still relies on selling billions of plain hamburgers, has been praised as "one of the most innovative American companies today," not only for its development of new menu items but also for changing people's expectations of the McDonald's experience.<sup>33</sup> New product development and marketing campaigns are generally based on extensive market research about consumer preferences as well as larger social and economic forces. All kinds of marketing research have but one end: to enable companies to sell products better by attracting and retaining customers.

#### 10.4.1: Product Development

Product development is a key element of marketing that is anchored in a company's overall strategic plan. Individuals engaged in product development assess the market demand for new products and design these products so as to meet this market demand. This process is undertaken not only for physical consumer products but also for more intangible services, which must also be kept current. **The ethical issues surrounding product development center on the economic and social values associated with product design, including safety considerations.**<sup>34</sup>

#### Example

In the automobile industry, product development focuses heavily on safety as a marketable feature in car design. However, safety as a consideration in the product development of automobiles must be balanced against a host of other factors—such as price, handling, fuel economy, and especially consumer appeal—and "safety" itself is fraught with uncertainty due to unforeseen circumstances.

Manufacturers should exercise "due care" in the development of new products when they involve difficult-to-foresee safety risks. Product developers need to take reasonable steps to minimize the risks present in new products, consistent, of course, with other relevant factors.



**Another challenge facing product developers centers on the economic value of new products.** Over time customers may lose interest in certain products as technology changes and new alternatives emerge. (Who today would buy an original iPhone?) Product developers, therefore, must develop new product lines in order to retain their position in the marketplace. This constant advancement can be beneficial for consumers as long as new products tangibly improve customer satisfaction. However, it can also lead to new products that offer little, if any, value to consumers but involve merely “change for change’s sake.” Even worse are new products that are intentionally designed to become obsolete in a short period of time, a practice known as “planned obsolescence.”<sup>35</sup>

### Example

Apple’s widely used iPhone has been cited as an example of this problem. Apple customers have complained that the popular iPhone is designed in ways that force existing customers to purchase new versions of the device on a regular basis. New software runs slowly on older editions of the iPhone, and not only is the battery difficult to replace, but a replacement costs almost as much as a newer phone.<sup>36</sup> Supporters of Apple’s iPhone offer reasons for each of these features. Newer mobile applications require updated processors, which are less suited for older software, and the inaccessibility of the battery is necessary for the iPhone’s sleek, aesthetic look.

Economists contend that “planned obsolescence” is rational economic strategy when a company is able to maintain control over a particular market. The more control that a company has in a market, greater is the likelihood that it will “build” obsolescence into its new products. Doing so guarantees continued sales when consumers have few alternatives in the market.<sup>37</sup> By contrast, higher levels of competition create stronger incentives for companies to develop products with greater longevity since consumers, given the choice, may prefer products without built-in obsolescence.<sup>38</sup> Planned obsolescence does not constitute a violation of the terms of fair and free market interaction as long as consumers are fully informed and not coerced in any way. (Eager consumers still line up to buy the latest iPhone.) Product development with intentional obsolescence is ethically problematic, however, when new product development becomes simply a way for companies to assure continued sales without enhancing the well-being of consumers.

**A final issue facing product developers concerns the harms associated with new products.** Apart from the safety of consumer products, there are other, more indirect harms that may result from how products are made and used. Adverse environmental impacts are a good example. New products can be designed in ways that utilize less

packaging, promote energy efficiency, or have reusable components. The ethical responsibility invoked by advocates of environmentally conscious or “green” design is that companies should avoid doing harm in the absence of proportional benefit. Responsible product development, in other words, should produce more benefits than harms, including indirect environmental harms associated with the production and consumption of new products.<sup>39</sup>

Striking this ethical balance requires that product development occur in creative ways that improve market share without disproportionately increasing the costs of production that are often associated with environmental efforts. The Sony Corporation, for example, has effectively implemented special environmental technologies in its standard product lines.

### Example

Sony sells a line of data projectors that use lasers rather than incandescent bulbs.<sup>40</sup> While the initial price of these laser projectors is higher than conventional projectors, customers save money over the life of the product due to lower energy costs and no need for bulb replacement. Moreover, laser technology is better for the environment since it uses no mercury.

## WRITING PROMPT

### Planned Obsolescence

Consumers often take a cynical view of planned obsolescence, particularly when it is applied to higher-priced products. What are some examples of products with built-in obsolescence that nonetheless provide some value *to the consumer*? Identify any products with planned obsolescence that would be considered indefensible from an ethical point of view. Describe the pros and cons of each product.

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## 10.4.2: Marketing Research

The knowledge produced by marketing research is derived from information collection and analysis. Because this knowledge is costly to acquire and has considerable competitive value, it is often proprietary in nature—closely guarded and held in confidence. Some marketing research is conducted by in-house company staffs, but most work in this area is done by research firms, including advertising agencies, and also by academic specialists.

The main ethical questions about marketing research involve the *kinds* of information it is acceptable to collect and the *means* used to collect the information.<sup>41</sup> The collection of information in marketing research is conducted in two general ways.

## What kinds of information are used for market research?

### Primary and Secondary Sources

The first collection method utilizes *primary* sources, such as customer surveys and questionnaires, structured interactions with focus groups, observations of customer behavior, and interviews with suppliers and competitors. Primary research allows companies to have significant control over what information is collected and how it is collected and analyzed. Because the skills needed for effective research are highly specialized, companies often hire marketing consultants to design and implement a primary research plan.

Marketing research also uses *secondary* sources, which includes potentially useful information that has been compiled by private research firms, academic researchers, and government agencies. Such secondary sources contain information on consumer preferences and attitudes, geographic and demographic information, and a variety of economic data. Secondary sources of information are useful in the first stages of marketing research because they are relatively easy to access and can help marketers plan their primary research efforts. Secondary research is often less product specific than primary research, but it provides significant background information on larger social, economic, and political trends.

Experts engaged in primary research need to gather and analyze a substantial amount of information obtained from studies involving human subjects. Any kind of research on human subjects raises ethical issues about proper treatment, especially with regard to the subjects' freedom, dignity, and well-being.<sup>42</sup> In particular, it is essential in most studies to avoid deception and gain the subjects' consent. Virtually all university-based and government-funded research requires that certain principles of research ethics be observed and that the research be approved and supervised by an Institutional Review Board (IRB).

#### One firm ethical limitation to marketing research concerns its purpose.

What is the purpose of any marketing research project, and is all information collected related to this purpose?

Primary research should be conducted in a manner that asks, and subsequently answers, a scientific question regarding social, psychological, or economic influences on customer behavior. It therefore follows that marketing research should not be viewed as an invitation to gather just any kind of information; rather, only information that is relevant to the scientific purpose of the study should be sought. The scientific purpose of marketing research also precludes selling a product under the guise of doing marketing research.<sup>43</sup> (Recall the encyclopedia sales tactic of gaining access to homes by claiming to be

conducting research, using questionnaires that were later discarded.)

A second limitation is that marketing research should not be unnecessarily intrusive, deceptive, or coercive. Marketers who rely upon *covert* means in conducting primary research—that is, who gain information without the awareness of the subjects—are particularly susceptible to a violation of this limitation.<sup>44</sup> Researchers sometimes gather information by observing consumer behavior in public spaces, such as shopping malls or airports. Because the people being observed are unaware and have not given any consent, it is incumbent upon the researcher to record and analyze this observational data in ways that preserve the anonymity of consumers.<sup>45</sup> Similarly, it is unethical for a researcher to pose as a stranger while interviewing shoppers about their attitudes. Researchers should inform subjects that research is being conducted; otherwise, the information would be gained under false pretenses, which is a form of deception.

## How can research be conducted more openly?

### Overt Research Methods

In *overt* forms of marketing research, in which subjects are aware of their role, research ethics requires that subjects give their informed consent.<sup>46</sup> Surveys, questionnaires, and focus groups should be administered voluntarily, with a clear explanation of the researcher's identity and the basic methods being used. Informed consent requires the subject be informed in advance of the purpose of the research and its potential impacts, if any, on the subjects' health or well-being.<sup>47</sup> If a researcher cannot provide full disclosure—for example, when doing so will taint the research results—then research ethics requires that an explanation be given for the lack of full disclosure.<sup>48</sup> Furthermore, research subjects should be allowed to withdraw from research during the process and participate anonymously, unless they have given consent for their identities to be revealed.

Finally, ethical conflicts can arise when marketing research firms are engaged by client companies that are concerned not only about research ethics but also with the use of research results for marketing purposes. Market research firms have a unique role in preserving the integrity of scientific inquiry, including the protection of research subjects and other, competing clients. A client company, however, may seek to use research results to gain advantage in the marketplace.<sup>49</sup> A marketing research firm, for example, could be asked by a client to provide confidential information about the identity of research subjects that could be used to sell certain products to them. In such cases, a firm faces a conflict between satisfying a client company and adhering to the principles of ethical marketing research.

## WRITING PROMPT

**Ethical Market Research**

Consider the type of information sought by marketing researchers and the methods used to collect this information. What are the greatest ethical concerns in marketing research?

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## 10.5: Deceptive Advertising

### 10.5 Describe the difficulties in defining what constitutes deceptive advertising and how it interferes with consumers' ability to make rational choices

A typical definition of advertising, from a marketing textbook, is that it is “a paid nonpersonal communication about an organization and its products that is transmitted to a target audience through a mass medium.”<sup>50</sup> So defined, advertising is only one kind of promotional activity. The others are publicity, sales promotion, and personal selling. Although most advertising is for a product or a service, some of it is devoted to enhancing the image of a corporation or advancing some issue or cause. Thus, a distinction is commonly made between product advertising on one hand and advocacy or cause-related advertising, including political campaign ads, on the other.<sup>51</sup> Advertising is also used to “sell” ideas, attitudes, and behaviors in order to benefit the targeted individuals and society generally. This kind of advertising on behalf of better health, environmental protection, and the like is called *social advertising*, which is explored later in this chapter.

All kinds of advertising are widely criticized. Exaggerated claims and outright falsehoods are the most obvious targets for complaints, followed closely by the lack of taste, irritating repetition, and offensive character. More recently, questions have been raised about the morality of specific kinds of advertising, such as advertising for alcohol and tobacco products and ads aimed at children. Particular ads are also faulted for their use of excessive sex or violence or for presenting negative stereotypes of certain groups. Other critics complain about the role advertising plays in creating a culture of consumerism. Advertising encourages people not only to buy more but also to believe that their most basic needs and desires can be satisfied by products. Finally, there is great concern about the potential of advertising for behavior control.

These objections to advertising have led to calls for government regulation and industry self-regulation.

Deceptive advertising is subject to regulation by the Federal Trade Commission (FTC), but many questions still arise about the definition of deception in advertising, as they do with deceptive sales practices, previously considered. The other objections to advertising are generally controlled by public opinion, to which advertisers must pay heed. Particularly offensive ads, for example, usually draw critical attention. The American Association of Advertising Agencies has adopted a code of ethics that addresses the more subtle issues of fairness and good taste in advertising.

### 10.5.1: Defining Deceptive Advertising

Roughly, an advertisement is deceptive if it has a tendency to deceive. On this definition, the deceptiveness of an ad does not depend solely on the truth or falsity of the claims it makes, but also on the impact the ad has on the people who see or hear it. It is possible for advertising to contain false claims without being deceptive and for advertising to be deceptive without containing any false claims. A patently false claim for a hair restorer, for example, might not actually deceive anyone. Furthermore, there are other advertising claims that are false if taken literally but are commonly regarded as harmless exaggerations or bits of puffery. Every razor blade, for example, gives the closest, most comfortable shave; every tire, the smoothest, safest ride; and every pain reliever, the quickest, gentlest relief. Some ad copy has no determinate meaning at all and cannot be characterized as either true or false.

Some writers even defend the literal falsehoods and meaningless babble of advertising as legitimate and even socially desirable. Perhaps the best known of these defenders is Theodore Levitt, who compares advertising to poetry:

Like advertising, poetry's purpose is to influence an audience; to affect its perceptions and sensibilities; perhaps even to change its mind . . . [P]oetry's intent is to convince and seduce. In the service of that intent, it employs without guilt or fear of criticism all the arcane tools of distortion that the literary mind can devise.<sup>52</sup>

**DECEPTION AND TRUTH** In order to see that true claims can still be deceptive, consider an ad for Anacin that prompted a complaint by the FTC in 1973. The ad asserted that Anacin has a unique painkilling formula that is superior to all other nonprescription analgesics.

#### How did the Anacin advertisement deceive consumers?

#### Compare Your Thoughts

Anacin is composed of two active ingredients, aspirin (400 mg) and caffeine (32.5 mg), but the sole pain-relieving component is aspirin. Aspirin itself is unique in the way that all chemical compounds are different from each other, and aspirin was

superior to any other pain reliever available at that time without a prescription. Therefore, it is literally true that Anacin contains a unique and superior painkilling formula: aspirin. The impression that the ad conveyed, however, was that only Anacin has this superior pain-relieving ingredient (false) and that consequently Anacin itself is superior to competing brands of analgesics containing aspirin (also false).

The basis of the FTC complaint, therefore, was not that the claims made for Anacin are literally false but that they gave rise to, or were likely to give rise to, false beliefs in the minds of consumers. Ads for Anacin also claimed that it causes less-frequent side effects. The position of the FTC is that the deceptiveness of this claim does not depend solely on whether it is true or false but also on whether the manufacturer, American Home Products, had sufficient evidence to back it up. That is, unsupported claims that turn out to be true are still deceptive, because, in the words of the court, “a consumer is entitled to assume that the appropriate verification has been performed.” Even if Anacin does cause less-frequent side effects, the consumer is deceived by being led to believe that there is evidence for the claim when there is not.

The Anacin case illustrates that whether a claim is deceptive, therefore, depends, in some instances, on whether there is evidence for it. The FTC has periodically reaffirmed this idea. The cosmetics company L’Oréal agreed in 2014 to settle charges that it made “unsubstantiated” scientific claims that its skincare products possessed genuine anti-aging properties. L’Oréal’s ads claimed to “boost genes’ activity and stimulate the production of youth proteins,” which, the FTC claimed, gave consumers the impression that there were unique scientific properties possessed by L’Oréal’s skin products. There was no evidence behind these claims, and the FTC maintained that L’Oréal engaged in deceptive advertising.<sup>53</sup>

## WRITING PROMPT

### Taking Advertisers at Their Word

Explain why the seriousness of deceptive advertising may depend upon the type of product or service being advertised. When, if at all, might you excuse a company’s use of exaggerated claims in an advertisement?

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**OBSTACLES TO A DEFINITION** The rough definition of deception that has been developed so far—namely, an ad is deceptive if it has a tendency to deceive—is not adequate, either for increasing our understanding of the ethical issues in deceptive advertising or for enforcing a legal prohibition against it. Unfortunately, the FTC has yet to offer a precise

legal definition of deception beyond describing its most general features, and none of the attempts by marketing theorists and others to define deception in advertising have been entirely successful.<sup>54</sup> An adequate definition of deception must overcome several obstacles.

**First, we need to consider whether the deception is due to the ad or the person.**

Is an ad deceptive if it creates a false belief in relatively few, rather ignorant consumers or only if it would deceive more numerous, reasonable consumers?

Ivan Preston recounts the story of a customer who failed to catch the joke in an ad for a novelty beer, Olde Frothingslosh, that proclaimed it to be the only beer with the foam on the bottom and was outraged to discover that the foam was on the top, like all other beers.<sup>55</sup> Or consider whether it was deceptive for Clairol to advertise in the 1940s that a dye will “color hair permanently.”<sup>56</sup> Only a few ignorant people would fail to realize the need to dye new growth. Yet the FTC, employing an ignorant consumer standard, found this claim deceptive.

**Second, an ad may not actually create a false belief but merely take advantage of people’s ignorance.** Consider health claims in food advertising. The word “natural,” which usually means the absence of artificial ingredients, evokes images of wholesomeness in the minds of consumers. Yet many food products advertised as natural contain unhealthy concentrations of fat and sugar and are deficient in vitamins and minerals.<sup>57</sup> The makers of some brands of peanut butter advertise their products as cholesterol-free even though cholesterol is present only in animal fats, so no brand of peanut butter contains any cholesterol. Is it deceptive for food advertising to make use of terms such as “natural” and “no cholesterol”? Even though the advertisers’ claims may not create false beliefs, they still depend for their effect on people’s lack of full understanding.

Central to any definition of deception in advertising is the concept of rational choice. Deception is morally objectionable because it interferes with the ability of consumers to make rational choices, which requires adequate information. But advertising is not intended to produce knowledgeable consumers, and so it should not be faulted for every failure to do so. Also, not every false belief is of such importance that consumers should be protected from it. But there is still a certain standard of rational consumer behavior, and advertising is deceptive when it achieves its effect by false beliefs that prevent consumers from attaining this standard. A proposed definition of deception is the following:

Deception occurs when a false belief, which an advertisement either creates or takes advantage of, substantially interferes with the ability of people to make rational consumer choices.

Whether an ad “substantially interferes” with the ability of people to make rational consumer choices assumes some view of what choices they would make if they were not influenced by an ad. At least two factors are relevant to the notion of substantial interference.

- One is the ability of consumers to protect themselves and make rational choices despite advertising that creates or takes advantage of false beliefs. Thus, claims that are easily verified or not taken seriously by consumers are not necessarily deceptive.
- The second factor is the seriousness of the choice that consumers make. False beliefs that affect the choices we make about our health or financial affairs are of greater concern than false beliefs that bear on inconsequential purchases. Claims in life insurance advertising, for example, ought to be held to a higher standard than those for chewing gum.

### 10.5.2: Applying the Definition

Both of these factors—the ability of consumers to protect themselves and the seriousness of consumers’ choices—can be observed in two cases involving the Campbell Soup Company.

#### **How did the Campbell Soup ads create false beliefs in consumers’ minds and interfere with rational decision making?**

##### **Examples**

Campbell ran afoul of the FTC in 1970 when it ran television ads showing a bowl of vegetable soup chock-full of solids.<sup>58</sup> This effect was achieved by placing clear-glass marbles on the bottom of the bowl to hold the solids near the surface. How does this case differ from one in which clear-plastic cubes are used instead of real ice in ads for cold drinks? In each case, false beliefs are created in consumers’ minds. The false beliefs that viewers have about the contents of a glass of iced tea as a result of using plastic cubes have no bearing on a decision to purchase the product (an iced tea mix, for example), whereas a decision to purchase a can of Campbell’s vegetable soup can definitely be influenced by the false belief created by the glass marbles. The consumers who buy the soup in the belief that the bowl at home will look like the one in the ad will be disappointed, but not the consumers who buy the iced tea mix. The soup ads have the potential, therefore, to interfere with the ability of consumers to make rational choices.

In 1991, the Campbell Soup Company was charged again by the FTC for ads stressing the low-fat, low-cholesterol content of some of its soups and linking these qualities to a reduced risk of heart disease.<sup>59</sup> The soups in question have reduced amounts of fat and cholesterol, but the ads failed to mention that they are high in sodium, which increases the

risk of some forms of heart disease. In the FTC’s judgment, Campbell was implying that its soups could be part of a diet that reduces heart disease, while at the same time refusing to tell consumers how much sodium the soups contain or that salt should be avoided by people concerned about heart disease. Consumers who are unaware of the salt content of canned soups might purchase Campbell products as part of a diet aimed at reducing the risk of heart disease. In so doing, they would be better off buying these products than high-salt soups that are also high in fat and cholesterol. But health-conscious consumers who are aware of the salt content might well make different, more rational consumer purchases instead.

Although these ads may not directly cause consumers to have false beliefs about certain Campbell products, the campaign depends for its success on consumer ignorance about the salt content of its soups and the link between salt and heart disease, and thus takes advantage of this ignorance. Whether Campbell would have an obligation to reveal the sodium content of its soups if it did not make health claims is debatable, but having made claims designed to lead people concerned about heart disease to buy its products, Campbell definitely has such an obligation. (Campbell eventually agreed to reveal the sodium content in ads for soups with more than 500 milligrams of sodium in an eight-ounce serving.)<sup>60</sup> The health claims made on behalf of some Campbell soups also involve the two factors that are a part of substantial interference. The salt content of a soup, unlike the amount of vegetable solids, cannot easily be verified by consumers, and the decisions consumers make to protect their health are of great importance. Accordingly, the FTC rigorously scrutinizes health claims in ads and holds them to a higher standard.

## 10.6: Irrational Persuasion

### **10.6 Recognize how different advertising practices use irrational persuasion techniques to influence consumers’ choices and the ethical arguments against these practices**

In 1957, Vance Packard frightened Americans with his best-selling book *The Hidden Persuaders*, which revealed how advertisers were turning to motivational research to discover the subconscious factors that influence human action. A pioneer in this area, Dr. Ernest Dichter, declared in 1941 that advertising agencies were “one of the most advanced laboratories in psychology” and that a successful advertiser “manipulates human motivations and desires and develops a need for goods with which the public has at one time been unfamiliar—perhaps even undesirable of purchasing.”<sup>61</sup> The key to success in advertising, according to Dr. Dichter, is to appeal to feelings “deep in

the psychological recesses of the mind” and to discover the right psychological “hook.”<sup>62</sup>

These claims are disturbing because of the possibility that advertisers have means of influence that we are powerless to resist. We now know that advertising and propaganda—advertising’s political cousin—have limited power to change people’s basic beliefs and attitudes. Still, there is evidence that the techniques of modern advertising are reasonably successful in playing on natural human desires for security, acceptance, self-esteem, and the like so as to influence consumer choices. In particular, inducing fear is a proven advertising technique.<sup>63</sup> Advertisers have also discovered that visual images are more powerful than written words, in part because they bypass our rational thought processes. Finally, advertising pervades our daily environment, and this constant exposure is bound to have some cumulative psychological effect.

The main concern of philosophers with advertising is whether the influence it exerts on consumers is consistent with a respect for personal freedom or autonomy.

Persuasion is a broad category that ranges from the laudable (e.g., guidance by parents and teachers) to the sinister (psychoactive drugs, psychosurgery, and torture, for example). Advertising does not involve extreme, sinister methods, of course. Still, advertising that cynically exploits deep-seated emotions or short-circuits logical thought processes can be criticized on the ground that it wrongfully deprives people of a certain amount of freedom in the making of consumer choices.

### 10.6.1: Threats to Free Choice

An advertising technique that might be faulted for interfering with freedom of choice is *subliminal communication*. There is a story, probably apocryphal, of an experiment in which a movie theater in New Jersey boosted sales of ice cream by flashing split-second messages on the screen during the regular showing of a film.<sup>64</sup> Several studies have reported a decrease in shoplifting in department stores when exhortations against stealing were mixed with the background music being piped over speakers.<sup>65</sup> Although many people believe that subliminal communication is a commonly used technique in advertising, there is little evidence to establish either its frequency or its effectiveness.<sup>66</sup>

The ethical argument against the use of subliminal communication in advertising, if it were effective in influencing consumer behavior, is quite simple. Richard T. DeGeorge expressed it in the following way:

Subliminal advertising is manipulative because it acts on us without our knowledge, and hence without our consent. If an ad appears on TV, we can tune it out or change stations if we do not want to be subject to it. If an ad appears in a magazine, we are not forced to look at it. In

either case, if we do choose to look and listen, we can consciously evaluate what we see and hear. We can, if we wish, take a critical stance toward the advertisement. All of this is impossible with subliminal advertising, because we are unaware that we are being subjected to the message. The advertiser is imposing his message on us without our knowledge and consent.<sup>67</sup>

Related forms of unconscious, if not subliminal, communication are *product placement*, which is the conspicuous placement of brand-name products in movies,<sup>68</sup> and *buzz marketing*, in which people who are natural trendsetters volunteer to create “buzz” about a product by casually talking about it, without revealing their purpose.<sup>69</sup> Because people are unaware that advertising is being directed at them by product placement or buzz marketing, they may not be prepared to evaluate it critically. Ads in newspapers and magazines and on television are clearly identified as such, so that we can separate them from news, entertainment, and other elements and treat them accordingly. Plugs in movies or conversations in bars catch us unawares, without our critical faculties at work, so to speak. We are not able to subject them to the same scrutiny as other ads because we do not recognize them for what they are.<sup>70</sup>

In all of these cases, the main complaint is that certain advertising techniques—namely, subliminal communication, product placement, and buzz marketing—do not allow people to use their capacity for critical evaluation, which is essential for freedom of choice. In the view of many philosophers, a choice is free to the extent that a person makes it on the basis of reasons that are considered by that person to be good reasons for acting. Freedom, in this view, is compatible with persuasion, but only as long as the techniques used do not undermine the ability of people to evaluate reasons for or against a course of action.

### 10.6.2: Dependence Effect

Another way in which advertising might involve nonrational persuasion is described by the economist John Kenneth Galbraith. He coined the term *dependence effect* to describe the fact that present-day industrial production is concerned not merely with turning out goods to satisfy the wants of consumers but also with creating the wants themselves. He has written,

As a society becomes increasingly affluent, wants are increasingly created by the process by which they are satisfied. This may operate passively. Increases in consumption . . . act by suggestion or emulation to create wants. Or producers may proceed actively to create wants through advertising and salesmanship. Wants thus come to depend on output.<sup>71</sup>

If wants depend on output, then production cannot be justified by the familiar claim of producers, “We only give the public what it wants.” These words are hollow if, as

Galbraith claims, these same producers determine what the public wants. Thus, he continues,

If the individual's wants are to be urgent they must be original with himself. They cannot be urgent if they must be contrived for him. And above all they must not be contrived by the process of production by which they are satisfied. For this means that the whole case for the urgency of production, based on the urgency of wants, falls to the ground. One cannot defend production as satisfying wants if that production creates the wants . . . Production only fills a void that it has itself created.<sup>72</sup>

The dependence effect, in Galbraith's formulation, involves a distinction between wants that originate in a person and those that are created by outside forces. F. A. von Hayek has pointed out that almost all wants beyond the most primitive needs for food, shelter, and sex are the result of cultural influences.<sup>73</sup> Thus, desires for art, music, and literature are no less created than desires for any consumer product. The creation of the former desires, moreover, is due in part to efforts by painters, composers, and novelists to earn a living. It is a non sequitur, therefore, to hold that wants that are created by the forces that also satisfy them are less urgent or important for that reason.

Even if it is not morally objectionable to create wants, advertising can still be criticized for creating desires by making irrational appeals.

Consider, for example, advertising that creates desires for expensive brands of liquor or designer clothing by appealing to people's yearning for status. Any clearheaded person should see the absurdity of thinking that status could be achieved merely by what one drinks or wears. A defender of advertising can reply that people do not really believe (irrationally) that they are "buying" status in making certain consumer purchases. Rather, advertising has succeeded in surrounding some products with an aura of status, so that people derive a certain satisfaction from purchasing and using those products and so (rationally) desire them.

### Is there any research to support this argument?

Consumer behavior suggests, however, that people really do make certain purchases because they want status. Vance Packard reported that in the 1950s, people expressed reluctance to buy small cars because they were less safe. Research showed, however, that a process of rationalization was taking place.<sup>74</sup> People wanted large cars for reasons of status but disguised their true motivation as a concern for safety. Today, many ads for luxury cars stress safety so that buyers can assure themselves of the rationality of their decisions, even though status is uppermost in their minds. (The headline of one ad asked, "How important is the elegance of Chrysler Fifth Avenue if it can't protect you in an emergency?")

Defenders of advertising point out that nonrational appeals are not necessarily unethical. A suitor, for example,

is unlikely to win the heart of his beloved with logical arguments alone; a romantic setting with candlelight and soft music improves the chances of success. Courtroom lawyers do not rely solely on strong legal arguments to win cases but also on their ability to play on the feelings of jurors.<sup>75</sup> Similarly, good advertising appeals on many levels; it is aesthetically pleasing, intellectually stimulating, and often humorous or heartwarming. In many ads, both rational and nonrational elements are combined for greater effect without reducing people's freedom of choice.

## WRITING PROMPT

### Creating Wants

As a consumer, are you aware of, or sensitive to, advertising that uses irrational persuasion techniques? For instance, give an example of an advertiser's attempt to associate a particular lifestyle or feeling with their product. Do such attempts come across as manipulative, a harmless part of modern consumer culture, or something else?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 10.7: Impact of Advertising

### 10.7 Assess the potential harm advertising poses to individuals and society and the responsibility of companies to consider the consequences of their marketing efforts

Advertising has a single aim: to get us to buy.

In doing so, it is inevitable that advertisers will produce other effects, without intending to do so and perhaps without even being aware that they do. Since advertisers have no reason to study the impact of advertising beyond its success in selling products and services, this task is left to advertising's many critics. Drawn from such diverse fields as psychology, sociology, communications studies, cultural history, and philosophy, these critics go beyond the generally beneficial economic function of advertising to explore its effects on individuals and society. Although critics of advertising offer wide-ranging observations,<sup>76</sup> their main points can be grouped under two headings: the impact of advertising on us as persons and the impact of advertising on society.

### 10.7.1: Impact on Persons

In getting us to buy, advertising also shapes us as persons—in our beliefs, attitudes, and values. Its impact on personality formation rivals that of parents, teachers, and religious leaders. American children watch an average of three to four hours of television daily, during which time they are

exposed to dozens of ads day in and day out. Although advertising to children has been criticized mostly for taking advantage of their lack of development,<sup>77</sup> both television advertising and television programming have an enormous impact on children's cognitive and emotional development.<sup>78</sup> As we mature, advertisements continue to shape our personalities.

**ADVERTISING TO CHILDREN** Although print and television advertising to children has been regulated for many decades, the availability of mobile telephones and tablet computers for use by children has created a need for new regulations. Applications marketed for children often partner with advertising networks that display advertisements, many of which contain adult material, including sexual themes and gambling, for example, or which use inappropriate images or messages that appeal to younger audiences.<sup>79</sup> Since online advertising networks do not automatically filter content for specific applications, some observers allege that children are presented with online advertisements that they would not normally experience in an offline environment. Furthermore, online advertising in one area easily leads to the placement of advertising across the Internet. So, children's use of a mobile or tablet app can lead to age-inappropriate ads appearing while they are conducting an Internet search or participating in a social network.<sup>80</sup>

**CREATING AVID CONSUMERS** What kind of person is created by this relentless barrage of advertising? Obviously, avid consumers. Beyond this, advertisers claim merely to be reflecting who we are. To this defense, the writer and critic Marya Mannes charges that advertising may be reflecting us incorrectly. She continues:

And if you reflect us incorrectly, as I believe you are doing, you are raising a generation of children with cock-eyed values as to what men and women and life and family really are.<sup>81</sup>

But even as consumers, how are we being trained?

Critics charge that advertising does not merely lead us to consume more than we would otherwise, leading to increasing indebtedness without an increase in happiness,<sup>82</sup> but makes us into consumers who work in order to spend. The media critic Richard W. Pollay writes, "At the least, advertising is seen as inducing us to keep working in order to be able to keep spending, keeping us on a treadmill, chasing new and improved carrots with no less vigor, even though our basic needs may be well met."<sup>83</sup> The impetus for this overconsumption comes, in part, from advertisers' ability to present goods as components of the good life and also as solutions to life's enduring problems. As another writer observes, "In consuming certain products, one buys not only a 'thing' but also an image, an image which invokes the belief and the hope of having the

good rather than the bad, happiness rather than misery, success rather than failure, life rather than death."<sup>84</sup> In short, advertising has successfully identified products with our conception of the good life so that consumption becomes an end in itself. To live is to consume.

A further charge is that advertising does not educate people to grapple with the complex problems of life. Life as presented in advertisements consists of simple, stereotypical situations for which the solution is some product. This is far different from the novel and complicated challenges of life that require interaction with other people in social settings. Admittedly, it is not the purpose of advertising to equip people with life skills, but in the absence of other training, people may fall back on the lessons that advertising teaches.

**IMPACT ON SELF-IMAGE** Critics allege that advertising has harmful effects on people's conception of themselves, which in turn affect their self-esteem and confidence. This charge has been leveled especially against ads that depict an ideal of female beauty that few women can meet. The authors of *Measuring Up: How Advertising Affects Self-Image* write,

Throughout the history of advertising, messages detailing the perfect female—her beauty, her societal roles, and her sexuality—have occupied a central role. These images . . . provide prescriptions for how we should look and be looked at, how we should feel and be made to feel, and how we should act.<sup>85</sup>

This kind of advertising, called "image advertising," has been blamed for a sense of inadequacy in women that has led to eating disorders, diet obsessions, unnecessary plastic surgeries, and various other psychological disorders. Some critics of advertising also hold image advertising responsible for violence against women.<sup>86</sup> Although some depiction of persons in advertising is unavoidable and even necessary, advertisers should be aware of the impact of image advertising and select images accordingly.<sup>87</sup>

In addition, some psychologists find that a society with pervasive advertising leads people to view themselves as marketable commodities in a process called the "objectification of the self." This phenomenon is known in personality theory as a "marketing orientation," in which a person thinks of himself or herself as an asset to be deployed for maximum gain.<sup>88</sup> In this orientation, personality traits such as friendliness and kindness are developed, not for their own sake but for the advantages that they bring in a market for personality. Although the "marketing orientation" is a personality disorder that cannot be blamed on advertising alone, an increasingly competitive economy that places a greater emphasis on personality forces people to "sell" themselves in the marketplace.



## 10.7.2: Impact on Society

Advertising has the power to affect not only persons individually but also groups in society. Thus, particular ads have been criticized for presenting damaging stereotypes of the elderly, women, and racial and ethnic groups. The sociologist Erving Goffman observed that many ads of the 1970s portrayed women as inept and childlike. One small example is that women's hands were often shown barely touching objects while men grasped things firmly, suggesting that women are weak and in need of a man's care.<sup>89</sup> Consumers are now quick to complain about such stereotypes, causing advertisers to be much more careful. More recently, criticism has been directed against advertising that encourages poor eating habits that cause obesity and preventable diseases and the purchase of gas-guzzling vehicles that harm the environment.

The greatest area of concern about the social impact of advertising has been in marketing to the poor, who, as a group, are targeted not only with harmful products but also with advertising that heavily promotes them. The products in question are mostly tobacco and alcohol. Thus, inner-city areas contain more billboards than do suburbs, and more of the billboards in the inner city advertise cigarettes and alcohol. A 1987 survey in St. Louis, for example, revealed that 62 percent of the billboards in predominantly black neighborhoods advertised cigarettes and alcohol compared with 36 percent in white neighborhoods.<sup>90</sup> A similar 2001 study in Chicago found that alcohol and tobacco billboards were three times more common in minority neighborhoods than in white areas.<sup>91</sup> The target marketing of the poor generally and the African American poor in particular is illustrated by a new cigarette brand from R. J. Reynolds Tobacco Company and a malt liquor from G. Heileman Brewing Company.

### Case: R. J. Reynolds and Uptown Cigarettes

In 1990, R. J. Reynolds, a division of RJR Nabisco, developed Uptown, a cigarette designed to appeal to black smokers. The introduction was scuttled after protests from outraged civil rights groups. The Secretary of Health and Human Services, Dr. Louis W. Sullivan, who is an African American physician, charged that Uptown was "deliberately and cynically targeted toward black Americans," and he urged the company to cancel plans to test-market the new brand. "At a time when our people desperately need the message of health promotion," he said, "Uptown's message is more disease, more suffering, and more death for a group already bearing more than its share of smoking-related illness and mortality."<sup>92</sup>

The development of Uptown was based on extensive marketing research. A light menthol flavor was selected because 69 percent of black smokers preferred menthol-flavored cigarettes compared with 27 percent for all smokers.

It was found that many blacks open a package from the bottom, and so the cigarettes were to be packed with the filter end pointing down. Researchers discovered that the name Uptown, which evokes images of sophisticated nightlife, drew the most favorable response from blacks in test groups, and the theme of elegance was reinforced by lettering in black and gold, which were chosen instead of the green that is more commonly used for menthol brands. The market testing for Uptown, which was scheduled to begin on February 5, 1990, in Philadelphia, involved print ads in black-focused magazines and newspapers and billboards and point-of-sale displays in black neighborhoods.

### Case: G. Heileman PowerMaster Malt Liquor

In June 1991, G. Heileman Brewing Company, no longer in business, announced the introduction of a new malt liquor called PowerMaster, which would compete in the growing "up-strength" malt liquor category.<sup>93</sup> With 5.9 percent alcohol (31% higher than the company's top-selling Colt 45 at 4.5% alcohol), this new product was launched in Heileman's unsuccessful attempt to emerge from bankruptcy. Since malt liquor is the drink of choice of many inner-city black males, Heileman's planned advertising focused on this group, with posters and billboards showing black male models. The name PowerMaster and the slogan "Bold Not Harsh" were designed to emphasize the high alcoholic content as well as mastery and boldness.

Like Uptown, PowerMaster incited a storm of protest for obvious reasons. Not only do inner-city blacks suffer higher rates of alcohol-related diseases, but the inner city experiences higher rates of violence and crime as a result of alcohol abuse. The ads might also be regarded as deceptive because of their appeal to mastery and boldness. One reporter for the *Los Angeles Times* quoted activists who charged that "alcoholic beverage manufacturers are taking advantage of minority groups and exacerbating inner-city problems by targeting them with high-powered blends."<sup>94</sup> And another reporter for the same newspaper wrote that "at issue is growing resentment by blacks and other minorities who feel that they are being unfairly targeted—if not exploited—by marketers of beer, liquor and tobacco products."<sup>95</sup>

**ADVERTISING IN CONTEXT** Although Uptown and PowerMaster were never marketed, the controversies surrounding these failed products show the need to be concerned with the social impact of advertising and the products themselves. The deleterious impacts of tobacco and alcohol on poor communities are due to factors beyond any single product or advertising campaign and may not add significantly to these problems. R. J. Reynolds denied that it was attempting to attract new smokers among blacks and maintained that the company was merely trying to take away business from its competitors. A spokesperson for the Beer Institute claimed that PowerMaster was not

being unfairly marketed to the poor. He said, “Everyone sells his product to the people who prefer them . . . People can make up their own minds about what products they prefer.”<sup>96</sup> However, as George G. Brenkert argues, marketers have a responsibility to consider not only the impact of individual products and advertisements but also the overall impact of their activities and those of others in the industry on groups that may suffer from problems related to other causes.<sup>97</sup> In considering the social impact of advertising, then, any one company must look at consequences in the context of all the forces operating in a community.

### WRITING PROMPT

#### Protecting Society

R. J. Reynolds and Heileman Brewing withdrew their marketing efforts for Uptown and Power Master in order to respond to growing public criticism. Were they right to do so, or are some correct in thinking that people should nonetheless be able to make their own choices? Explain your reasoning.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 10.8: Internet Advertising

### 10.8 Examine how Internet advertising and the online collection and use of personal information challenge the rights of individuals to privacy, autonomy, and fair treatment

The frontier for advertising today is the Internet. Just as the development of radio and later television moved advertising from print to the airwaves, the development of the Internet has opened new possibilities for advertising in cyberspace. Advertising on the Internet is driven primarily by the use individuals make of this medium. The relevant behavior that shapes Internet advertising includes people’s activity on websites, including communication through blogs, media websites, and social networks. In all of these venues, marketers rely upon information provided by individual users to place the advertisements directed at them. The placement of these advertisements raises ethical issues not only about privacy, but also about the three principles of marketing ethics: freedom, fairness, and well-being.

#### 10.8.1: Online Placement

Large Internet companies, such as Google and Yahoo, earn the vast majority of their revenue from selling advertising space and providing advertising-related services to other websites. Google, the largest and most prominent Internet content provider, generated 91 percent of its 2013 annual revenue through advertising.<sup>98</sup> Google earns income

through two technology platforms: its internationally recognized Internet search engine and its “ad network,” which brings companies seeking to place advertisements together with websites looking to sell advertising space.

#### How do Google’s AdWords technology and AdSense network service work?

Google’s AdWords technology allows companies to place ads on Google’s search engine site in order to reach the most receptive online audience. They do so by paying Google to place a short, text-based advertisement on the search engine’s results when a Google user types specific terms or phrases. A user who searches for “used cars” in Google will receive a list of search results with the first two or three likely to be sponsored advertisements by companies that either sell used cars or else provide related services. The advertiser in AdWords does not pay Google unless users actually click on the sponsored advertisements. Thereafter, Google is paid on a “per click” basis that is based on the amount of Internet traffic that is diverted from Google to the companies that sponsor advertisements.<sup>99</sup> Google’s AdWords promises advertisers the most sophisticated ad placement algorithms so that even small changes in search terms can alter the ads that appear to specific users.

The marketing advantages of AdWords technology are obvious. Traditional forms of advertising on radio, television, and print media are very limited in their ability to target specific groups. But Google virtually guarantees that individuals who receive a sponsored advertisement are looking for the products that the advertiser is seeking to sell. This technology offers advertisers the ability to avoid the inevitable inefficiencies associated with advertising to large groups in which a large percentage of viewers have no interest in the products being advertised.

Google’s ad network service AdSense offers a parallel service to companies seeking to place ads online. It essentially targets advertisements to specific visitors on different “client” sites across the Internet. AdSense is embedded in a client’s website and utilizes a number of variables to determine which advertisements should appear to particular visitors. These include the type of site hosting the advertisement, the product being advertised, and the previous activities of the site’s visitors as recorded from their Internet activities. From a user’s Internet Protocol (IP) address, browsing history, and recent purchases, AdSense is capable of inferring a range of personal information, including that person’s marital status, ethnicity, geographic location, lifestyle characteristics, and political affiliation.<sup>100</sup> Google, in turn, utilizes the data it collects from host sites and sponsored advertisers to better refine its ad placement technology. AdSense grows in sophistication as it “learns” from the behavior of Internet users across the sites on which it places advertisements.

The dominance of Google has also given rise to a marketing effort commonly called “search engine optimization.”<sup>101</sup> As more and more commerce is facilitated through

the Internet, advertisers are keenly interested in knowing how their company's website can appear in search engine results *without* using paid advertising services such as Google's AdWord or AdSense. Therefore, retailers have sought to uncover how search engine algorithms function, what terms are effective in generating traffic, and how consumers actually use terms on search engines.

Although Google dominates ad placement on the Internet, social networking sites, most notably Facebook, are not far behind. Social networks provide a virtual space for people to share information about their lives. Facebook's social network, the largest with more than 1.3 billion active participants in 2014, is particularly attractive to marketers because its platform enables users to voluntarily associate with or "follow" companies. Facebook has become an integral part of many companies' marketing activity, enabling promotions and targeted communication with loyal customers. Facebook's network is thus a low-cost, effective alternative to traditional advertising and brand development, as well as to Google's AdWord and AdSense services.

Facebook offers a range of services to advertisers for targeting ads to specific segments of the population. These services utilize Facebook's ability to track each user's "likes," interests, birth date, relationship status, educational background, e-mail address, logon locations, and other pieces of user-specific data.<sup>102</sup> Facebook's site prompts advertisers to specify the features of the products or services that they intend to sell, as well as the characteristics of their likely customers. Facebook's own analytic software then suggests a variety of further demographic and geographic filters that enable even more targeted placement of ads on Facebook users' profile pages. This development is viewed as an attempt by Facebook to capture some of the advertising market share held by ad networks such as Google's AdSense.<sup>103</sup>

## 10.8.2: Ethics of Placement

The services offered by Google and Facebook demonstrate that the most effective online advertising strategies are those that apply ever-more sophisticated information technologies to target individuals who are the most likely to respond. At the heart of current Internet advertising is the ability of these companies to predict the identities and behaviors of Internet users, which can be done effectively only if users' activities and personal data are tracked and analyzed over time. One of the central ethical issues surrounding advertising on the Internet, therefore, centers on the rights of consumers to maintain control over their identities. A second ethical issue with the placement of Internet advertisements concerns the use of techniques that thoroughly integrate ads into the functional design and appearance of a content provider's website. These efforts make it difficult for Internet users to distinguish information that is authored by content providers from the information authored by advertisers.

**CONTROLLING DATA** Arguably, the most pressing ethical issue involved in online advertising centers on the degree to which Internet consumers can reasonably determine how their personal data are collected and used. The absence of such control reduces *autonomy*, which, in this case, consists in consumers' ability to self-determine what personal information is made available to others and how this information is used. In order for consumers to retain their autonomy online, they require *knowledge* of how their personal information is being collected and used as well as the *opportunity* to decide whether the collection and use of their information take place at all. In general, consumers do not possess a reasonable level of knowledge regarding the methods used by websites to track and analyze their Internet activities, nor do they have sufficient opportunity to make crucial decisions about collection and use.<sup>104</sup>

Some websites disclose what information they collect, how they go about collecting this information, and how users' data might be used. However, these disclosures suffer from some basic problems.

1. First, the privacy disclosures on websites are often imprecise and overly broad.

### Example

The retailer Nordstrom states that it may share a customer's personal information with other members of the "Nordstrom family of companies" and with "service providers" that help it market products and services, manage Nordstrom's programs and operations, complete customer requests, and administer "surveys, contests, sweepstakes and product reviews."<sup>105</sup> A customer seeking to maintain control over his or her personal information could not reasonably be expected to anticipate what specific companies and service providers are covered by this blanket disclosure.

2. Second, standardized disclosures, which are often difficult to locate on a company's website, are usually phrased in technical language.

### Example

Nordstrom's site discloses that it uses "web beacons," "cookies," and "flash cookies" as different tools to collect information about customers, leaving viewers with the task of understanding the meaning of these technical terms and of deciding how to respond. Furthermore, Nordstrom has different protocols to "opt out" of being monitored depending upon what technology a customer wants to avoid. Critics of online advertising note that the average online customer has neither the time nor the expertise to read, understand, and effectively respond to the content of such disclosures.

3. The inability of consumers to fully understand the methods used to collect and analyze their personal information is increased by the fact that commercial

websites do not collect information directly but rather work with third parties—such as the advertising services run by Facebook and Google—to implement their advertising strategies across the Internet.<sup>106</sup>

### Example

An online shopper with Nordstrom must provide an identifying e-mail address as part of the transaction. If that e-mail address matches the address of a Facebook user, then Facebook’s advertising service allows for Nordstrom to place an ad on Facebook that will appear to the “matched” user on future occasions. This capability effectively allows retailers to pair certain ads with particular individuals whom they know to be past customers. It also allows Facebook to identify the products purchased on other websites, thereby enhancing the behavioral profile of each user.<sup>107</sup>

In general, third-party ad networks, such as Google’s AdSense, are not automatically identified by commercial websites that host ad placement technology, and these primary hosts are not required to disclose whether or how third parties collect and track personal information. Furthermore, commercial sites do not usually place limits on the information that third parties can collect about its visitors, nor do they limit third parties’ ability to exchange users’ data with other ad networks. One study estimates that the highest volume websites on the Internet are monitored directly and indirectly by hundreds of third parties once information sharing between ad sponsors and networks is taken into account.<sup>108</sup> Even if users had knowledge of how primary hosts and third parties collect their personal information, it is nearly impossible to know the extent of information flows between companies engaged in online tracking. This difficulty in knowing has prompted proposals to require that host sites provide full and complete disclosure about what information they allow third parties to collect and how this third-party data collection takes place.<sup>109</sup>

## WRITING PROMPT

### Online Ads Targeted to You

You want to buy your friend, an avid cook, a birthday present. You visit an online store that you’ve bought from once before, and without signing in, a notice at the top of the page welcomes you back by name. You buy your friend a set of barbecue grilling utensils. The next time you open your browser, the ads shown in the sidebars include products such as gas grills and accessories, as well as deals from local gourmet butcher shops. Similar ads begin to appear on your social media homepages and news websites that you visit daily. You also begin to receive e-mails offering subscriptions to cooking magazines. Why do some think this kind of targeted online advertising violates your privacy? Develop a response to this point of view.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

**OPT-IN VERSUS OPT-OUT** A lack of full consumer knowledge about the online tracking methods used by advertisers prompts an even deeper question:

Should consumers have the right to formally opt *in* to information collection *before* commercial websites compile personal information, or should opt-out be the default standard?<sup>110</sup>

An opt-in requirement would allow consumers to decide whether their information is collected in the first place. The current practice of allowing consumers to opt *out* of being tracked places the burden on consumers to investigate a company’s data collection policies and then take specific steps to control their personal data with each website or ad network. However, privacy advocates argue that the standard practice should be to refrain from personal data collection unless consumers have explicitly offered their consent. This consent requirement would constitute more adequate protection of consumers’ autonomy since their presumed interests in limiting the availability of their personal information would occur by default, without requiring any special action on their part.

**PROTECTING IDENTITY** Advertisers note that only “nonidentifiable” data are collected online, meaning that the information gathered by commercial websites and third parties is not attached to a particular person’s discernible identity. Critics respond that while a consumer’s behavioral profile can vary in degree of specificity, individuals who are “assigned” certain characteristics nonetheless have a portion of their identities exposed in a manner inconsistent with their preferences.<sup>111</sup> This partial identification is particularly troublesome if it is attached to a particularly sensitive characteristic. For example, Google searches on sexually transmitted diseases have generated ads offering support for HIV positive individuals.<sup>112</sup>

These concerns have prompted legislators and consumer groups to propose limits on the type of information that Internet companies can collect about individuals.<sup>113</sup> Sensitive financial, demographic, and health-related information, they maintain, should remain fully under consumers’ control, because they are so fundamental to an individual’s right to determine who possesses even partial knowledge of their identity. The goal of protecting users’ identity is complicated by the fact that even seemingly innocuous information can be used to identify individuals if enough of it is subjected to data analysis. Online businesses and ad networks now have the technological capacity to pinpoint the actual identity of Internet users by combining and comparing data. One study noted that just a few pieces of nonpersonalized information gathered from credit card transactions, combined with information from past online purchases and social media activity, can serve to “reidentify” particular consumers 90 percent of the time.<sup>114</sup>

Internet advertising remains ethically problematic because the absence of knowledge about how information is collected and used and the opportunity to respond effectively undermines individuals' ability to be fully autonomous.<sup>115</sup> Transparency is not enough; the disclosures made by websites and ad networks enable autonomy only if users can adequately understand them and respond effectively.

**NATIVE ADVERTISING** Media companies and advertisers understand the importance of clearly distinguishing independent editorial content from the messages communicated by advertisers. Consumers of traditional media still have the opportunity to differentiate news stories and related programming from the sponsored content paid for by companies. In the age of the Internet, however, the boundary between the information offered by content providers and that presented by advertisers has begun to blur.

This is largely the case because of so-called "native advertising" techniques.

*Native advertising* is a process of selling advertising space in a manner that mimics the design platform and functional operation of the website on which an ad appears.

Yahoo's main website sells "sponsored content" that is displayed independently from the ads associated with a user's search engine requests. This sponsored content, unlike that promoted by ad networks such as Google's AdWords, looks like independent news or information items collected by Yahoo for the benefit of its users. A financial services company, for example, may sponsor content on Yahoo's site by writing an "article" about the upcoming collapse of the stock market. When users select that article, they might find not only a discussion about the stock market but also subtly placed information about a nearby investment seminar being hosted by the company.

Ethical concerns about such native advertisements involve two related problems.

**First, is it clear to users whether the content they are viewing is sponsored?** The relative level of independence of information is important to Internet users' ability to make fully informed—and, therefore, autonomous—decisions about important matters. If users take sponsored information on a content provider's website to be independent, then they may easily grant it authority that it does not deserve. Advertisers point out that sponsored content is usually accompanied by small graphic disclaimers that it is an advertisement. Critics respond, however, that the "native" appearance of the sponsored content makes it too easy to overlook any such disclaimers, leading users to interpret the advertisements as informational rather than promotional in nature.

**Second, the use of native advertising strategies has extended beyond websites such as Yahoo to places where consumers rely heavily on the independence of the website.** Traditional print media companies, such as *Forbes*

and the *New York Times*, now make use of sponsored content alongside their own news stories.<sup>116</sup> Careful readers may be able to distinguish between advertisements and journalists' news stories. Nonetheless, worry remains that the well-crafted presentation of sponsored content, in combination with the habits of Internet users, will effectively obscure the difference between independent and promotional information.

Although there are no specific, enforceable rules regarding the use of native advertising, the FTC has recently begun examining whether native advertising on the Internet involves deceptive or misleading practices.<sup>117</sup>

## 10.9: Social Advertising

### 10.9 Summarize the significance of social advertising and the ethical issues associated with it

Advertising, whether traditional or online, has the potential to impact society positively as well as negatively. Aside from the useful economic role that advertising plays in promoting products and service, its techniques of persuasion can also be used to address social problems. Beginning in the 1970s, social welfare organizations turned to marketers to conduct advertising campaigns to raise money for charities, to support educational and cultural institutions, to promote healthy lifestyles, and to protect the environment, among other worthy aims.

This development is known as *social advertising*<sup>118</sup> or social marketing, which may be defined as "the application of commercial marketing technologies to the analysis, planning, execution, and evaluation of programs designed to influence the voluntary behavior of target audiences in order to improve their personal welfare and that of their society."<sup>119</sup> Insofar as many of the causes promoted by social advertising are morally desirable, this movement puts advertising in the service of ethics.

The admirable aims of social advertising do not make it free of ethical concerns. Indeed, whereas conventional advertisers need to consider only the avoidance of deception, manipulation, and undesirable social impacts, social advertisers must address a number of ethical challenges. None of these ethical challenges suggest that social advertising ought not to be done. Indeed, social advertisers have provided a great public service. Nevertheless, social advertising involves ethical questions that must be satisfactorily answered for each advertising campaign. Ironically, social advertising may be more ethically problematic precisely because of its good intentions.

The main ethical challenges of social advertising are the following.<sup>120</sup>

- First, since social advertisers seek to change people's beliefs, attitudes, and behaviors in ways that benefit themselves and society, they must evaluate the

desirability of these changes and be sure that an advertising campaign will produce them.

**Example:** The goal of preventing heart disease is uncontroversial, although the social advertisers must be sure that the recommended preventive measures are effective. However, on controversial matters, such as preventing AIDS or teen pregnancy, the ends in question, as well as the means, need to be carefully justified. At issue is some conception of people's welfare, and on this there may be reasonable disagreement.

- Second, the social problems addressed by social advertising are ones on which public discussion may be desirable.

**Example:** There are many important issues about protection of the environment that need informed debate and understanding. Insofar as advertising uses standard techniques of persuasion, people may be led to change their behavior with regard to the environment (recycling, for example) without any real public discussion taking place (say, becoming informed about

greenhouse gases). By forestalling public discussion, social advertisers may produce short-term benefits at the expense of long-term gains.

- Third, social advertising may be effective in changing individuals' behavior, but the solutions to many social problems require more sweeping social, political, and economic change.

**Example:** Obesity can be reduced by persuading people to eat less, but significant reductions can be achieved only if fast-food companies and food manufacturers offer more healthy products. By focusing primarily on individual behavior, social advertising neglects broader social change.

- Fourth, since advertising techniques are designed to persuade without necessarily enabling the target audience to understand what they are being asked to do or why, social advertising runs the risk of being manipulative. Instead of a two-sided conversation in which the people exposed to advertising participate, social advertising operates paternalistically and undemocratically.

## Conclusion: Marketing and Advertising

The ethics of marketing is concerned chiefly with how producers treat their customers. What goods to produce and how to sell them are among the most basic decisions that businesses make, and the impacts of these decisions on the well-being of consumers are many and varied. However, the interactions between producers and consumers take place primarily in a market, and so much of the ethics of marketing is the ethics of the buyer-seller relationship, in which honesty and fair dealing are the main moral requirements. Understanding markets also requires that marketers have an appreciation for how social research can be performed in a manner that respects the freedom and well-being of individual consumers. Much of this chapter deals with marketing practices in which sales techniques and the pricing, labeling, and advertising of products are manipulative, deceptive, or otherwise unfair to consumers. In addition, marketing, especially advertising, has social consequences that producers must handle responsibly.

### End-of-Chapter Case Studies

This chapter concludes with three case studies.

In a highly competitive marketing environment, innovation is a virtual necessity. However, this search for an innovative

competitive edge often leads to the invention of ethically questionable practices. Among these practices have been a food manufacturer's adoption of dual price rates for retail sales ("McCormick & Company's Pricing Strategy"), a bank's use of its website to identify receptive customers ("Capital One's Online Profiles"), and the novel marketing scheme of a nutrition products company ("Herbalife: A Pyramid Scheme?"). In the first and third cases, the companies risked violating long-established consumer protection laws, but in all three cases, the specific wrongs committed against consumers, business partners, or competitors are difficult to discern.

### Case: McCormick's Pricing Strategy

McCormick & Company, Inc., is well known to anyone who visits a grocery store. The Maryland-based company manufactures and sells spices, herbs, packaged seasonings and mixes, meat tenderizers, and other gourmet spice blends marketed under such brand names as Schilling, Select Seasonings, Spice Trend, and Fifth Seasons. McCormick has grown impressively, recording annual sales in 1998 of \$623 million to over \$4 billion in 2013.<sup>121</sup> It is the world's largest spice company by sales volume with a ubiquitous presence among grocery store chains across the United States.

Like any food manufacturer, McCormick continually seeks to improve the visual presence of its products in grocery store aisles. The position and location of its products are extremely important for its managers, who know that where a product is placed in a store can influence the decisions of shoppers.<sup>122</sup> Thus, the exact shelf location of high-volume products, the display of special promotions, and the physical arrangement of other products sold by competitors are matters that manufacturers like McCormick routinely try to influence.<sup>123</sup>

## Dual Rates

Throughout the 1990s and early 2000s, McCormick developed a number of related business practices that caught the attention of industry observers. One of these unusual practices was maintaining two lists of the prices for its products. McCormick had a single, national list of prices for its product lines sold to retail customers, which McCormick's management referred to, internally, as the "A" list.<sup>124</sup> This list, however, belied the reality of what McCormick would regularly charge grocery store chains to stock its products. McCormick commonly entered into sales agreements on a retailer-by-retailer basis that provided substantial discounts off the "A" list prices. Favored retail chains paid lower prices for products than those charged to other less-favored chains. In most circumstances, McCormick offered price discounts for the sale of established product lines and were not used as incentives to sell new or forthcoming McCormick items.<sup>125</sup> Favored retailers tended to be large regional or national grocery store chains, which left smaller chains or independent retailers to pay higher prices.

These facts alone did not make McCormick's pricing strategy unique. Many food manufacturers charge retail chains different prices based on distribution costs, regional competition, and the presence of specialty products. What was unusual were the methods used by McCormick to lower the prices charged to favored retail chains. The effective price reductions were made by offering free goods, price discounts that were not reflected on sales invoices (so-called "off invoice" discounts), up-front cash payments to stock McCormick products, and sales-contingent rebates to retailers based on the number of McCormick items sold in a specific period of time.<sup>126</sup> The company negotiated the "net" price paid by a particular grocery retailer on an individual basis to determine the overall "deal rate," which was the "A" list price less the total cost of the discounts, payments, and rebates that were offered to the retailer. Different grocery store chains paid different amounts for the same products based on the price reductions negotiated with McCormick.

These "deal rates" were noteworthy because McCormick's price reductions were contingent on the shelf space that stores devoted to the company's products.

- First, unlike cases in which large grocery store chains demand price discounts from manufacturers, McCormick voluntarily offered its lower pricing options—including the rebates, up-front cash payments, and free products—in conjunction with an informal agreement that stores would continue to dedicate a certain percentage of shelf space to McCormick brands.<sup>127</sup> In some situations, the sales agreements required that 90 percent of all shelf space displaying spices and seasonings within a store be dedicated to McCormick's product lines.<sup>128</sup>
- Second, McCormick also entered into sales agreements that required stores to reserve "prime" aisle locations for certain products. McCormick had intimate knowledge of store designs and aisle layouts and used this information to leverage access to the most desirable shelf space.<sup>129</sup>

## Price Discrimination?

Regulators at the FTC alleged that McCormick & Company engaged in illegal "price discrimination" because different grocery store chains were effectively charged different prices (or different "deal rates") for the same products with identical qualities in comparable markets. Moreover, the rates offered to favored grocery store chains did not reflect a "good faith attempt to meet the equally low price of a competitor" or otherwise indicate justifiable "cost savings" by doing business with the retailer.<sup>130</sup> In other words, the costs of doing business, the presence of competition, and the relative quality of the products sold by McCormick did not motivate the lower effective prices paid by certain grocery store chains. Regulators claimed that the lower prices offered to favored chains had two negative impacts on competition in the retail spice market.

- First, McCormick's pricing arrangements privileged large grocery chains over smaller retail outlets.<sup>131</sup> Large chains received more attractive "deal rates" and, therefore, had access to lower supplier prices than did smaller chains or independent retailers.
- The second impact of the favored pricing plans was that McCormick could exclude, in effect, non-McCormick spice and herb products.<sup>132</sup> Maintaining a dominant aisle presence in large chains was an effective means to accomplish this goal of excluding the competition.

The FTC noted in its formal inquiry into McCormick's pricing that the payments and rebates offered to reduce the "deal rate" for favored customers resembled "slotting-type" allowances, although this situation was unique in that the payments and rebates in question were offered by the manufacturer rather than requested by retailers.<sup>133</sup> Although slotting allowances are not automatically illegal under federal law, the FTC alleged that the grocery store

chains with which McCormick conducted business had few comparable alternative spice suppliers from which to choose. Consequently, the financial incentives offered by McCormick reduced the ability of smaller retailers to compete with large chains. The Robinson-Patman Act, enforced by the FTC, “prohibits sellers from charging competing buyers different prices for goods of like grade and quality” when such differential treatment substantially lessens competition in a line of commerce.<sup>134</sup>

The majority of FTC commissioners who reviewed McCormick’s pricing arrangements maintained that the company’s willingness to indirectly determine how the largest, most prominent national grocery stores allocated shelf space to spices and seasonings created a situation in which competition among retailers was reduced. The dissenting commissioners noted, however, that while McCormick clearly had the potential leverage to promote its product lines among large retailers in the manner alleged, there was no evidence that the pricing arrangements were used in ways that actually inflicted “competitive harm” on smaller grocery store retailers.<sup>135</sup>

#### SHARED WRITING: McCORMICK’S & COMPANY’S PRICING STRATEGY

What exactly makes McCormick’s sales practices unfair or otherwise unethical? Who was the most harmed by McCormick’s policies: competing spice companies, stores without special sales agreements, or consumers?

Review and comment on at least two classmates’ responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Capital One’s Online Profiles

In 2010, Capital One Financial Corporation began using special software to create instantaneous profiles of visitors to its website. Constructed from information such as recent purchases, web browsing history, and geographic location, these profiles were used mainly to determine which credit card offers to display on a visitor’s computer screen.<sup>136</sup>

### Customer Profiles

In the case of one customer, Carrie Isaac, Capital One’s website used “cookies” left by other websites, her Internet Protocol (IP) address, and other technical information transmitted by her computer to conclude that she was a member of the “White Picket Fences” group, a profile for

customers who are thought to be middle-class parents who live in a metropolitan suburb and have reliable creditworthiness. Capital One used sophisticated algorithms to determine correctly that she was female and a young parent and that she earned approximately \$50,000 annually, had attended, and shopped at discount department stores. On the basis of this information, Capital One’s software displayed a credit card designed for people of average creditworthiness with no annual fee and an initial monthly interest rate of zero percent, increasing to 19.8 percent thereafter. Overall, Capital One’s inferences about Ms. Isaac’s identity were accurate.

The same appeared to be true of another potential customer, Paul Boulifard. Capital One’s website focused on Mr. Boulifard’s residence in Nashville, Tennessee, and his interest in travel. It displayed the “VentureOne Rewards” credit card to him, which allows the accumulation of points that can be used to purchase airline tickets. The images surrounding this card included a beach scene and the slogan “Still Searching? Get double miles with Venture.”

In the case of Karyn Morton, however, Capital One’s software was less accurate. Ms. Morton was profiled as a member of the “City Roots” segment. Capital One accurately determined that she was a homeowner living in Detroit, a member of the National Association for the Advancement of Colored People (NAACP), and a regular reader of major newspapers. It inaccurately inferred that Ms. Morton was retired without children, had little education, and was living on a modest income of \$28,000. She actually earned three times that amount, was 33 years old, and held a law degree. Capital One offered Ms. Morton two credit card options, one for individuals with average credit scores and an interest rate of 24.9 percent and one for customers with excellent credit scores and an interest rate of 13.9 percent.

### Use of Profiles

Capital One emphasized at the time that it did not use the information gathered in a visitor’s online profile to determine who actually received certain lines of credit. It used only the concrete information voluntarily offered by a customer on a credit application for such purposes. Capital One, therefore, did not violate the Equal Opportunity Credit Act, a federal law that prohibits banks and other lenders from targeting or restricting financial services based on race, ethnicity, national origin, or residency.<sup>137</sup> Capital One claimed that it simply made an “educated guess” about what it thought customers would want and featured products based on those inferred preferences.<sup>138</sup>

Capital One’s efforts at product placement were not unique. Other online retailers have used similar methods in setting online prices.

- In 2012, Orbitz, the online travel site that provides low-priced deals on car rentals, hotel rooms, and airfares,



offered the same products to different customers at different prices.

- Customers who used desktop computers with an Apple operating system paid 30 percent more for hotel rooms compared with customers who booked the same rooms using computers with a Microsoft operating system.<sup>139</sup>
- The office supply giant Staples has sold products at different prices depending upon a customer's proximity to competitors' stores. A recent investigation found that the Staples.com website displayed different prices to different people by "estimating" their location based on their computer's IP address. Staples considered the distance from a competitor's store, such as OfficeMax or Office Depot, and if a store was located within 20 miles, then a discounted price was shown.<sup>140</sup>

## Profiling Technology

Capital One arguably refined a common practice. Marketing decisions involving product placement and pricing have long been guided by the concept of "segmentation." The marketplace is composed of groups of customers—or segments—with different experiences, demographic traits, and preferences. The rise of information technology and e-commerce has enabled marketers to modify the manner in which they sell products based on their knowledge of the segment to which a potential customer belongs. Segments provide a useful, if imperfect, guide to quickly predict a customer's likely purchases.

Capital One's software was engineered by a little-known supplier, [x+1], Inc. Neither this fact nor the exact methods employed by the profiling software were disclosed to visitors on the website. Capital One did disclose that it collected and used visitors' IP addresses, browser and operating system information, "cookies" placed by other websites, navigation preferences, social media activity, and geographic data. These disclosures, however, were placed within the "privacy" section of Capital One's website, located at the bottom of the user's screen in small font. This is typical in the online commercial environment. Internet users are rarely cognizant of how they are being profiled, and privacy disclosures are not easy to find without some effort.<sup>141</sup> Users also expect their online activity to take place in a market that provides impersonal, even anonymous, interaction. This expectation is apparently important to Internet users. Marketing studies<sup>142</sup> indicate that consumers typically find product and price customization problematic when there is a lack of transparency regarding the customization efforts. When consumers expect standardized sales experiences, customized experiences are considered unfair, but if there is an expectation that product offers or prices will differ between consumers, then variations are perceived as less problematic.<sup>143</sup>

Capital One's algorithms were focused exclusively on the information that could be gleaned from visitors' computers at the moment that they started using Capital One's website. More advanced technology exists, however, which can combine the up-front data provided by a visitor's computer, web browser and IP address with larger sources of data that contain historical records of Internet transactions, in-person retail purchases, and e-mail addresses.<sup>144</sup> This technology could conceivably enable customer profiling that combines online with offline behavior. It also holds the prospect of eliminating anonymity in Internet transactions. As more data, such as ZIP codes, telephone numbers, birth dates, e-mail addresses, and online social activities, are accessed and used by online advertisers, the accuracy with which companies can place a customer within a segment, or even construct a concrete identity profile, is increased. This capability would expand and refine the ability of companies like Capital One to customize experiences for each consumer.

### SHARED WRITING: CAPITAL ONE'S ONLINE PROFILES

Why is Capital One's online advertising seen by many to be a violation of consumers' privacy? Explain why some find Capital One's method of product placement discriminatory. Do you find this objection persuasive? If not, what problems do you have with this argument?

Review and comment on at least two classmates' responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Herbalife: A Pyramid Scheme?

During an emotional presentation on December 20, 2012, William A. "Bill" Ackman, the CEO of the hedge fund Pershing Square Capital Management, publicly called the nutrition products company Herbalife a "massive pyramid scheme."<sup>145</sup> His comments caused a considerable stir and focused attention on the company's unusual marketing system. Pyramid schemes can be wildly successful in the short term, but they inevitably collapse, usually with great losses to most participants. If Bill Ackman was correct, the very existence of Herbalife was in question.

### A Novel Marketing System

Founded in 1980 by Mark Hughes, Herbalife manufactured and marketed shakes, energy drinks, and various

nutritional supplements and weight-management products, which promised to “change people’s lives” by inspiring “customers to live a healthy, active life.”<sup>146</sup> In 2013, the company’s robust, heavily international business produced \$4.8 billion in sales and \$527 million in net income.<sup>147</sup> Consumers, however, would not find Herbalife products in grocery stores or other retail outlets. The distribution and sales of Herbalife products took place only through a network of 3.7 million distributors, described as “Independent Herbalife Members,” who were located in approximately 90 countries.<sup>148</sup> These distributors were attracted to Herbalife as an opportunity for starting a small business with little training or investment. They typically sold products first to family members, friends, coworkers, and other acquaintances before attempting to sell to the public. The most successful Herbalife distributors opened “Nutrition Clubs” and sold Herbalife products alongside lifestyle coaching, fitness classes, and on-site nutrition seminars.

This unusual approach is known as “multilevel marketing.” Distributors made money by selling Herbalife’s products and retaining a portion of the sale income as a commission. They also earned commissions by recruiting other individuals to become distributors and selling products to them. These new recruits became part of a distributor’s “downline,” and members of a downline, in turn, could become distributors for still more sales agents, thereby creating additional levels. When any member in a downline sold products, either to the public or to other distributors, the original distributor received an added commission. Distributors, therefore, had an incentive to develop extensive sales networks with multiple levels, since each level provided an added source of commissions.<sup>149</sup>

The key issue for Mr. Ackman was whether Herbalife’s distribution network was actually selling Herbalife products to consumers rather than simply loading up new distributors within its own network. A classic pyramid scheme involves making money solely from the revenue generated by recruiting new members in every increasing numbers, so that a few near the top of the pyramid-shaped structure are the beneficiaries of money that flows from the much larger, growing base. If the revenues are generated not by genuine sales to consumers but merely from purchases by new members, then the return to members higher in the pyramid are possible only if products can continue to be sold to yet more newly recruited distributors in geometrically growing numbers. Like a chain letter, in which, say, 10 people send a letter to 10 more people and so on, the number of people needed to keep a pyramid scheme alive can quickly reach tens of millions.

Any scheme that requires an impossible number of new participants is inherently unsustainable, and its promotion would constitute a kind of fraud because of promises to deliver the impossible—in this case, returns to everyone in the pyramid from a continued supply of new

recruits. Eventually, when new recruits become scarce, the source of revenue dries up and most people in the scheme lose much of their investment. Fraud may also be committed in the recruitment of new members if relevant information is not effectively communicated. For example, the returns to Herbalife distributors did not begin until downline members had sold several thousand dollars’ worth of products, which many would fail to do if sales were made mainly to a declining number of new members.<sup>150</sup> Furthermore, downline members who failed to return unsold products within the allowable time would be left holding worthless inventory.

## An Investor’s Concerns

Ackman raised a number of concerns. First, he noted that Herbalife’s recommended prices for distributors were two to three times higher than similar products marketed by other brands.<sup>151</sup> Why would consumers pay these comparatively higher prices? And if Herbalife products were actually being sold to consumers, how could the company remain competitive over time with such high prices? Adding to Ackman’s skepticism was the fact that Herbalife products were regularly sold through online auction sites such as eBay more cheaply than the retail prices listed by distributors.<sup>152</sup> The low prices online indicated to Ackman that the products purchased by distributors at the bottom levels of the distribution network could not effectively be sold to consumers directly and that the excess inventory of distributors was being dumped, at a loss.

Second, Ackman’s analysis indicated that Herbalife distributors earned more than 10 times as much from “recruiting rewards” as they did from selling products to retail customers. This element of Herbalife’s compensation structure was part of an overall business model that compensated sales agents in ways that were “facially unrelated” to the sale of products to ultimate users, because distributors were paid commissions based on the “suggested retail price” of what is ordered from Herbalife rather than on the actual prices charged to consumers.<sup>153</sup> Herbalife also contractually prevented Nutrition Clubs from engaging in direct retail sales to walk-in customers and barred advertising by precluding the use of logos, signs, posting of prices, and the display of Herbalife products. Herbalife distributors were also prohibited from selling products at wholesale prices to other would-be retailers.<sup>154</sup>

Third, drawing upon internal Herbalife documents, Ackman cited some troubling statistics regarding the success of Herbalife’s distributors.<sup>155</sup>

- As far back as 2005, Herbalife’s own public disclosures noted that 60 percent of distributors who qualified as Herbalife “supervisors” did not re-qualify, which is to say that their higher rank and compensation in the distribution network were not renewed.

- Ackerman also noted that from 2006 to 2012, there was a general failure rate of 90 percent among distributors.<sup>156</sup> In 2011, 98 percent of distributors received less than \$1,000 in commissions, and only 0.7 percent of distributors were making a five-figure annual income.

The problems suggested by these statistics were accentuated by the fact that low-income individuals from minority ethnic groups were heavily represented in Herbalife's distributor network. The League of United Latin American Citizens (LULAC) estimates that, at any one time, 60 percent to 83 percent of Herbalife distributors in the United States were Hispanic. Much of Herbalife's business was conducted abroad, mostly in less developed parts of the world. Although the company did not disclose financial information by country, critics claimed that Herbalife aggressively recruited new distributors from poor communities that were desperately seeking accessible business opportunities. Herbalife promotional materials emphasized significant earnings potential, the freedom of being "your own boss," and the advantages of finding immediate sales within a close-knit community. Recruiters used "rags-to-riches" stories that illustrated how individuals struggling to make ends meet subsequently found wealth in their own Herbalife business. An array of Latino civil rights organizations, including LULAC and Hermandad Mexicana, have called for regulation against what they perceive to be Herbalife's predatory recruitment practices.

In 2014, prompted in part by Ackman's analysis and by growing concern among legislators, the FTC and the Securities and Exchange Commission (SEC) began investigations into whether Herbalife's multilevel marketing

constituted a pyramid scheme.<sup>157</sup> Herbalife steadfastly maintains that it is not a pyramid scheme. Its senior managers cite the company's steady cash flow, its growth in gross revenue and net income, and its continued existence since 1980 as basic reasons for rejecting Mr. Ackman's charges. Herbalife officials also pointed to Pershing Square Capital's financial interest in Herbalife's demise and criticized Ackman's highly visible efforts to hasten it. The hedge fund managed by Ackman engaged in short-selling by investing \$1 billion in options that would pay off if Herbalife's stock significantly decreased in value. At the end of 2014, Bill Ackman was still sticking with his audacious \$1 billion bet.

### SHARED WRITING: HERBALIFE: A PYRAMID SCHEME?

In what respects, if any, did Herbalife's recruitment of distributors clearly involve fraud or manipulation? Why might someone argue that the problem in this case is a problem with any system of "multilevel marketing"? Is there such a thing as legitimate multilevel marketing or are all such systems unethical pyramid schemes?

Review and comment on at least two classmates' responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

### Chapter 10 Quiz: Marketing and Advertising

# Chapter 11

## Ethics in Finance



### Learning Objectives

- 11.1** Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients
- 11.2** Assess the significance of the three main elements of fairness in financial markets and the ethical issues introduced by new financial instruments and practices
- 11.3** Summarize the two main arguments against insider trading and the challenges in applying these theories to its prevention and prosecution
- 11.4** Analyze the ethical issues raised by various hostile takeover tactics and what they suggest about the rights and fiduciary duties of officers and directors

### Case: Goldman Sachs and the Abacus Deal

The e-mail message quoted below was sent to a friend in January 2007.

“The whole building is about to collapse anytime now . . . Only potential survivor, the fabulous Fab . . . standing in the middle of these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!”<sup>1</sup>

The “fabulous Fab” in this bragging e-mail was Fabrice Tourre, a Goldman Sachs banker, who handled a series of securities known as Abacus. One particular issue, Abacus 2007-AC1, worth about \$1 billion, was sold in April 2007 to two banks, which, within nine months, lost the whole of their investments. Their billion dollar losses constituted a corresponding billion dollar gain, however, for a savvy investor who stood on the other side of what was essentially a bet on the soundness of a selected group of home mortgages. Neither “fabulous Fab” nor Goldman Sachs was a survivor in this Abacus deal, since Mr. Tourre was convicted in a jury trial of defrauding investors and forced to pay \$825,000,<sup>2</sup> and Goldman Sachs settled with regulators by paying \$550 million in penalties and restitution and by agreeing to certain reforms.<sup>3</sup>

### Creating the Deal

In early 2007, the U.S. housing market was showing signs of weakness, but investors were still eager for securities that generated returns from the high home prices. Few observers at the time expected the financial crisis that would erupt in August of that year. One investor, John Paulson,<sup>4</sup> doubted the soundness of the housing market, and he sought, through his hedge fund, Paulson & Co., to make investments that would pay off if homeowners began defaulting on their mortgages. Accordingly, he asked Goldman Sachs to create a security based on home mortgages from which he could benefit if defaults increased. Goldman Sachs had created a novel type of security under the Abacus label that could serve this purpose. They were known as “synthetic” securities since they contained no assets, such as income from actual home mortgages, but were based on the performance of other securities containing home mortgages. These synthetic securities were essentially bets on whether other securities—in this case, collections of home mortgages—would retain or lose their value.

### Did Goldman Sachs create Abacus 2007-AC1 with the intention of committing fraud?

#### Compare Your Thoughts

The challenges for Goldman Sachs were,

1. to base the security, which became Abacus 2007-AC1, on other securities that were likely to decline in value, and
2. to find purchasers for the Abacus security who had confidence that it would retain its value, which it would if the underlying mortgages were sound.

The first of these challenges was easily met: John Paulson provided a list of 123 securities composed of mortgages in which the homeowners, he believed, would soon default. Most of these were adjustable-rate mortgages extended to borrowers with low credit scores in such states as Arizona, California, Florida, and Nevada. Any security based on this list was, in his view, almost certain to lose value, quickly. The harder task was to find a buyer for Abacus 2007-AC1. Mr. Tourre and others at Goldman Sachs recognized that Abacus 2007-AC1 could be sold only if buyers were unaware of Mr. Paulson's role in selecting the securities that underlay it, and if they believed that the securities had been selected for their value by a reputable independent party.

For the role of Portfolio Selection Agent, Goldman Sachs turned to ACA Management, which had extensive experience with these kinds of securities. From John Paulson's list of 123 questionable securities, ACA accepted 55 and, in consultation with Paulson, included 35 others to form a group of 90 mortgage-backed securities as the basis of Abacus 2007-AC1. In the marketing materials for Abacus 2007-AC1, no mention was made of John Paulson's role in selecting the underlying securities nor of the use he would make of the Abacus security as a means for profiting from defaults among the referenced mortgages. Any buyer of such a security would understand that some other party stood on the other side of the transaction and held a different view of the security's value; otherwise, the transaction could not occur. However, any disclosure that this other party with an adverse interest had taken part in the creation of the security would be not only highly unusual but also ordinarily a deal breaker.

In creating Abacus 2007-AC1, Goldman Sachs had no financial interest apart from the \$15 million dollar fee it would receive from John Paulson. Although the bank had heavy exposure to the U.S. housing market and would suffer great losses if mortgage defaults increased, it was in the process of reducing its exposure to such losses by making the same kind of bearish investments as John Paulson. Fabrice Tourre and other bankers at Goldman Sachs shared the belief of John Paulson that securities like Abacus 2007-AC1 were very likely to lose value, and so the bank was investing in other securities—but not this one—which would benefit from distress among homeowners.

## Collapse of the Deal

Two buyers for Abacus 2007-AC1 were found: IKB Deutsche Industriebank, based in Dusseldorf, Germany, which purchased \$150 million of the risk exposure, and ABN AMRO, a Dutch bank, which agreed to assume the remainder of \$909 million. The deal closed on April 26, 2007. Both banks were longtime clients of Goldman Sachs and had purchased many similar securities from Goldman Sachs in the past. IKB invested in Abacus 2007-AC1 not only ignorant of John Paulson's role in the creation of this security but also believing that he was investing in it on the same side as the banks, with

an interest in the security maintaining its value, not in its decline. Goldman Sachs bankers apparently did nothing to correct IKB's misunderstanding. ABN AMRO reduced its risk by insuring its investment with ACA Capital Holdings, the parent company of ACA Management. The preponderance of the risk in this security was thus assumed by a company that had ample reason to know that the selection of the underlying mortgages was influenced by a party with an interest in the security's failure.

By the end of January 2008, 99 percent of the mortgages underlying Abacus 2007 AC1 had been downgraded, thus triggering \$1 billion in payments to John Paulson. The loss of IKB's \$150 million investment added to other losses related to the U.S. housing market, which had resulted in the need for a government bailout of the bank in August of 2007. In the meantime, ABN AMRO had been taken over by the Royal Bank of Scotland (RBS), and when ACA Capital was unable to meet claims, RBS was forced to pay approximately \$840 million, most of which went to John Paulson. RBS, too, required a government rescue to prevent a collapse from its extensive losses in mortgage-related investments. Goldman Sachs itself lost approximately \$100 million in the deal.<sup>5</sup>

## Did Goldman Sachs and Fabrice Tourre admit guilt in this case?

In April 2010, the Securities and Exchange Commission (SEC) brought action against Goldman Sachs and Fabrice Tourre for committing fraud in the marketing of Abacus 2007-AC1. The SEC suit alleged that the marketing materials for the security contained misleading statements and omitted important information. Most notably the role of John Paulson in the selection of the underlying securities was concealed, and ACA was represented as the sole party selecting the underlying securities. Also alleged was that Mr. Tourre had misled ACA into believing that Paulson & Co. was investing approximately \$200 million on the same side of the transaction as ACA and not, as was the case, taking an opposite position. The former CEO of ACA Capital testified in court that had the full truth about Paulson's role been known at the time, "This transaction would have been stopped in its place."<sup>6</sup> Goldman Sachs settled with the SEC without admitting or denying the allegations, but Fabrice Tourre opted for the jury trial in which he was found guilty. He subsequently left Goldman Sachs to pursue a Ph.D. in economics at the University of Chicago.

In the same month that the SEC suit was filed, Goldman Sachs CEO Lloyd Blankfein faced critical questioning before a U.S. Senate committee about the propriety of selling securities backed by home mortgages at the same time that the bank was seeking to reduce its exposure to them by making investments that would pay off in the event of a decline in the housing market. Mr. Blankfein insisted that the clients were "sophisticated investors," who were capable of understanding the risks they were taking and who desired to take certain risks. He denied that a bank has any duty in such cases to protect clients from

harming themselves. He explained further, “There are parts of the business where you are a money manager, where you owe a duty to the client. There are parts of the business where you are a principal and you are giving the client what it wants

and it’s understood . . . that the product you do [give] delivers what they expect to have. But the markets couldn’t work if you had to make sure it was good for them.”<sup>7</sup>

## Points to Consider . . .

Some cynics jokingly deny that there is any ethics in finance, especially on Wall Street. This view is expressed in a thin volume, *The Complete Book of Wall Street Ethics*, which claims to fill “an empty space on financial bookshelves where a consideration of ethics should be.”<sup>8</sup> Of course, the pages are all blank! However, a moment’s reflection reveals that finance would be impossible without ethics. The very act of placing our assets in the hands of other people requires immense trust. An untrustworthy stockbroker or insurance agent, like an untrustworthy physician or attorney, finds few takers for his or her services. Financial scandals shock us precisely because they involve people and institutions that we should be able to trust. Broken trust is not the only casualty of financial scandals. The financial crisis that began in 2007 dramatically illustrated the damaging impact that misconduct by banks and other financial institutions can have on the global financial system.

Finance covers a broad range of activities, but the two most visible aspects are financial markets, such as stock exchanges, and the financial services industry, which includes not only commercial banks but also investment banks, mutual fund companies, both public and private pension funds, and insurance companies. Less visible to the public are the financial operations of a corporation, which are the responsibility of the chief financial officer (CFO). This chapter focuses first on ethics in financial services, including the offering of consumer financial products such as credit cards, and on financial markets, by examining market regulation, which is the subject of securities law and enforcement by the Securities and Exchange Commission (SEC). Because Wall Street was shaken in the 1980s by instances of insider trading by prominent financiers and by hotly contested battles for corporate control by some of the same financiers, this chapter also covers the topics of insider trading and hostile takeovers.

## 11.1: Financial Services

### 11.1 Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients

The financial services industry still operates largely through personal selling by the following agents:

- stockbrokers,
- insurance agents,

- financial planners,
- tax advisers, and
- other finance professionals.

Personal selling creates innumerable opportunities for abuse, and although finance professionals take pride in the level of integrity in the industry, misconduct still occurs.

Such misconduct has created a public demand that financial services professionals be held to the legal standards of a fiduciary in their interaction with customers instead of being mere sellers of products.<sup>9</sup>

Customers who are unhappy over failed investments, high fees, or rejected insurance claims are quick to blame the seller of the product, sometimes with good reason. For example, two real estate limited partnerships launched by Merrill Lynch & Co. in 1987 and 1989 lost close to \$440 million for 42,000 investor-clients.<sup>10</sup> Known as Arvida I and Arvida II, these highly speculative investment vehicles projected double-digit returns on residential developments in Florida and California, but both stopped payments to investors in 1990. At the end of 1993, each \$1,000 unit of Arvida I was worth \$125, and each \$1,000 unit of Arvida II, a mere \$6.

The Arvida partnerships were offered by the Merrill Lynch sales force to many retirees of modest means as safe investments with good income potential. The brokers themselves were told by the firm that Arvida I entailed only “moderate risk,” and company-produced sales material said little about risk while emphasizing the projected performance. Left out of the material was the fact that the projections included a return of some of the investors’ own capital; that the track record of the real estate company was based on commercial, not residential, projects; and that eight of the top nine managers of the company had left just before Arvida I was offered to the public.

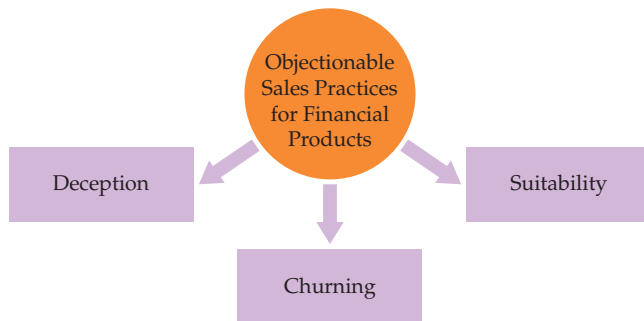
This case raises questions about whether investors were deceived by the brokers’ sales pitches and whether material information was concealed. In other cases, brokers have been accused of *churning* client accounts by conducting excessive trades in order to generate higher fees and of selecting unsuitable investments for clients. Other abusive sales practices in the financial services industry include *twisting*, in which an insurance agent persuades a policy holder to replace an older policy with a newer one that provides little if any additional benefit but generates a commission for the agent, and *flipping*, in which a loan officer persuades a borrower to repay an old loan with a new one, thereby incurring more fees. In one case, an illiterate retiree, who was flipped 10 times in a four-year

period, paid \$19,000 in loan fees for the privilege of borrowing \$23,000.

This section discusses three objectionable practices in selling financial products to clients—namely:

1. deception,
2. churning, and
3. suitability.

**Figure 11.1** Objectionable Practices In Selling Financial Products



### 11.1.1: Deception

The ethical treatment of clients requires salespeople to explain all relevant information truthfully in an understandable, non-misleading manner. Critics of the financial services industry complain that brokers, insurance agents, and other salespeople have developed a new vocabulary that obfuscates rather than reveals. The traditional broker is now more likely to be identified as a “financial adviser” or a “wealth manager.” Financial products have become “investment choices” or “financial planning vehicles.”<sup>11</sup> Today, saving for retirement involves selecting among 401(k)s or other Individual Retirement Accounts (IRAs). The tax-deferred benefit of these retirement accounts is sometimes misrepresented as tax-exempt. The agents of one insurance company represented life insurance policies as “retirement plans” and referred to the premiums as “deposits.”<sup>12</sup> Salespeople also avoid speaking of commissions, even though they are the source of their compensation. Commissions on mutual funds are “front-end” or “back-end loads,” and insurance agents, whose commissions can approach 100 percent of the first year’s premium, are not legally required to disclose this fact—and they rarely do.

Deception is often a matter of interpretation. Promotional material for a mutual fund, for example, may be accurate but misleading if it emphasizes the strengths of a fund and minimizes the weaknesses. Figures of past performance can be carefully selected and displayed in ways that give a misleading impression. Deception can also occur when essential information is not revealed. Thus, an investor may be deceived when the sales charge is rolled into the fund’s annual expenses, which may be substantially higher

than the competition’s, or when the projected hypothetical returns do not reflect all charges. As these examples suggest, factually true claims may lead typical investors to hold mistaken beliefs about expenses and returns of the funds they select.

Deception aside, what information ought to be disclosed to a client?

The Securities Act of 1933 requires the issuer of a security to disclose all material information, which is defined as information about which an average prudent investor ought reasonably to be informed or to which a reasonable person would attach importance in determining a course of action in a transaction. The rationale for this provision of the Securities Act is both fairness to investors, who have a right to make decisions with adequate information, and the efficiency of securities markets, which requires that investors be adequately informed. Most financial products, including mutual funds and insurance policies, are accompanied by a written prospectus which contains all of the information that the issuer is legally required to provide.

The analysis of deception by a financial service provider is similar to that provided for deceptive advertising. In general, a person is deceived when that person is unable to make a rational choice as a result of holding a false belief that is created by some claim made by another. That claim may be either a false or misleading statement or a statement that is incomplete in some crucial way.

Consider two cases of possible broker (mis)conduct:

1. A brokerage firm buys a block of stock prior to issuing a research report that contains a “buy” recommendation in order to ensure that enough shares are available to fill customer orders. However, customers are not told that they are buying stock from the firm’s own holdings, and they are charged the current market price plus the standard commission for a trade.

#### Has there been any deception or wrongdoing?

One might argue that if an investor decides to purchase shares of stock in response to a “buy” recommendation, it matters little whether the shares are bought on the open market or from a brokerage firm’s holdings. The price is the same. An investor might appreciate the opportunity to share any profit that is realized by the firm (because of lower trading costs and perhaps a lower stock price before the recommendation is released), but the firm is under no obligation to share any profit with its clients.

On the other hand, the client is buying the stock at the current market price and paying a fee as though the stock were purchased at the order of the client. The circumstances of the purchase are not explained to the client, but does the broker have any obligation to do so? And would this knowledge have any effect on the client’s decision?

2. A broker assures a client that an initial public offering (IPO) of a closed-end fund is sold without a commission and encourages quick action by saying that after the IPO is sold, subsequent buyers will have to pay a 7 percent commission. In fact, a 7 percent commission is built into the price of the IPO, and this charge is revealed in the prospectus but will not appear on the settlement statement for the purchase.

### Is the broker guilty of deception?

In this case, a client might be induced to buy an initial offering of a closed-end mutual fund in the mistaken belief that the purchase would avoid a commission charge. The fact that the commission charge is disclosed in the prospectus might ordinarily exonerate the broker from a charge of deception, except that the false belief is created by the broker's claim, which, at best, skirts the edge of honesty. Arguably, the broker made the claim with an intent to deceive, and a typical, prudent investor is apt to feel that there was an attempt to deceive.

## 11.1.2: Churning

Churning is defined as excessive or inappropriate trading for a client's account by a broker who has control over the account, with the intent to generate commissions rather than to benefit the client. A practice known as "reverse churning" also occurs when investors are placed in accounts that do not involve enough activity to warrant the fixed fees they generate for a broker.<sup>13</sup>

Although churning and "reverse churning" occur, there is disagreement on the frequency or the rate of detection. The brokerage industry contends that churning is a rare occurrence and is easily detected by firms as well as clients. No statistics are kept on churning, but complaints to the SEC and various exchanges about unauthorized trading and other abuses have risen sharply in recent years.

The ethical objection to churning is straightforward:

It is a breach of a fiduciary duty to trade in ways that are not in a client's best interests.

Churning, as distinct from unauthorized trading, occurs only when a client turns over control of an account to a broker; and by taking control, a broker assumes a responsibility to serve the client's interests. A broker who merely recommends a trade is not acting on behalf of a client or customer and is more akin to a traditional seller, but a broker in charge of a client's portfolio thereby pledges to manage it to the best of his or her ability.

Although churning is clearly wrong, the concept is difficult to define. Some legal definitions offered in court decisions are as follows: "excessive trading by a broker disproportionate to the size of the account involved, in order to generate commissions,"<sup>14</sup> and a situation in which "a broker, exercising control over the frequency and volume

of trading in the customer's account, initiates transactions that are excessive in view of the character of the account."<sup>15</sup> The courts have held that for churning to occur a broker must trade with the intention of generating commissions rather than benefiting the client. The legal definition of churning contains three elements, then:

1. the broker controls the account;
2. the trading is excessive for the character of the account; and
3. the broker acted with intent.

The most difficult issue in the definition of churning is the meaning of "excessive trading."

- First, whether trading is excessive depends on the character of the account. A client who is a more speculative investor, willing to assume higher risk for a greater return, should expect a higher trading volume.
- Second, high volume is not the only factor; pointless trades might be considered churning even if the volume is relatively low.
- Third, churning might be indicated by a pattern of trading that consistently favors trades that yield higher commissions.

Common to these three points is the question of whether the trades make sense from an investment point of view. High-volume trading that loses money might still be defended as an intelligent but unsuccessful investment strategy, whereas investments that represent no strategy beyond generating commissions are objectionable, no matter the amount gained or lost.

An SEC report on churning concluded that the compensation system in brokerage firms was the root cause of the problem.<sup>16</sup> The report identified some "best practices" in the industry that might prevent churning, including ending the practice of paying a higher commission for a company's own products, prohibiting sales contests for specific products, and tying a portion of compensation to the size of a client's account, regardless of the number of transactions. However, an SEC panel concluded that the commission system is too deeply rooted to be significantly changed and recommended better training and oversight by brokerage firms.

### WRITING PROMPT

#### Preventing Abusive Practices

Explain whether "best practice" recommendations and self-monitoring by brokerage firms can be as effective as government regulations in preventing churning. What are some possible obstacles to effective government regulation of the practice?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit



### 11.1.3: Suitability

In general, brokers, insurance agents, and other salespeople have an obligation to recommend only suitable securities and financial products. However, suitability, like churning, is difficult to define precisely. The rules of the National Association of Securities Dealers include the following:

In recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holding and as to his financial situation and needs.<sup>17</sup>

The most common causes of unsuitability are:

1. unsuitable **types of securities**, that is, recommending stocks, for example, when bonds would better fit the investor's objectives;
2. unsuitable **grades of securities**, such as selecting lower-rated bonds when higher-rated ones are more appropriate;
3. unsuitable **diversification**, which leaves the portfolio vulnerable to changes in the markets;
4. unsuitable **trading techniques**, including the use of margin or options, which can leverage an account and create greater volatility and risk; and
5. unsuitable **liquidity**, which would occur if the securities could not be easily sold.

Limited partnerships, for example, are not very marketable and are thus unsuitable for customers who may need to liquidate the investment.

Of course, the critical question is, when is a security unsuitable? Rarely is a single security unsuitable except in the context of an investor's total portfolio. Investments are most often deemed to be unsuitable because they involve excessive risk, but a few risky investments may be appropriate in a well-balanced, generally conservative portfolio. Furthermore, even an aggressive, risk-taking portfolio may include unsuitable securities if the risk is not compensated by the expected return. Ensuring that a recommended security is suitable for a given investor thus involves many factors, but people in the financial services industry offer to put their specialized knowledge and skills to work for us. We expect suitable recommendations from physicians, lawyers, and accountants. Why should we expect anything less from finance professionals?

Suitability, as well as deception, is also at issue in controversies over the rates and fees involved in credit and debit cards. Issuing banks depend heavily on the interest charged for credit balances and on the fees imposed for late payments, overdrafts, and other services or penalties. Many of the abuses by banks in rates and fees were addressed in the 2009 Credit Card Accountability,

Responsibility, and Disclosure Act (CARD).<sup>18</sup> In drafting this legislation, Congress affirmed some key ethical principles in the sale of financial services to the public. Additional regulation for cards and other financial products is provided by the Consumer Financial Protection Bureau (CFPB), created by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, and by the self-regulatory body, the Financial Industry Regulatory Authority (FINRA). Despite this regulation, many abuses of credit and debit cards continue to be committed by issuers.<sup>19</sup>

#### **What ethical principles of suitability guide the regulation of all consumer financial products, including credit and debit cards?**

##### **Disclosure and Fairness**

The first principle is that these products should be offered with full, accurate *disclosure* of relevant information without deception, concealment, or guile. The terms, whatever they may be—in case of credit cards, about interest rates, service or penalty fees, payment requirements, liability for unauthorized use, resolution of disputes, notification of changes, and the like—should be clearly disclosed in ways that can be easily known and understood by consumers. These terms are commonly presented to users in contracts that are difficult—if not impossible for some—to read, due to arcane legal language presented in small, faint type. This lack of readability is probably no accident: Card issuers certainly benefit from ignorant or befuddled consumers.

A second ethical principle of suitability is *fairness*. Fairness in the terms of credit or debit cards is difficult to formulate simply since so many different aspects of use are involved. What is a fair interest rate is obviously different from the fairness of a late-payment fee or the resolution of a billing error. Whether the terms of cards are fair can be questioned further when they are presented on a take-it-or-leave-it basis with little difference between issuers, so that users cannot be said to have consented in any meaningful sense. Other financial products raise yet different issues of fairness.

Issues of fairness of the terms in card agreements arise mainly about interest rates and fees. Not only are very high interest rates often charged, but the methods for calculating them are unduly complicated and easily manipulated for the issuer's advantage.

##### **Examples:**

- Different portions of a cardholder's balance may have different interest rates, and in such cases payments may be credited first to reduce the amount owed on portions that carry the lowest interest rate, regardless of when this balance was incurred. This method of crediting payments, which allows balances with higher interest to remain unpaid, obviously benefits the issuer at the expense of the user.

- Also, issuers have been accused of setting rules for overdrafts of debit cards in ways that trigger them more often and increase the fees owed. This may be done, for example, by a now-banned practice of debiting the largest expense of a day first, regardless of the order of purchases. As a result, overdraft fees may be levied on earlier purchases that would not have produced overdrafts had they been debited in the order the purchases were made. Furthermore, overdraft fees in debit and credit cards are incurred only if the user agrees to overdraft protection; otherwise, the card is refused at the point of sale.

The CARD Act now requires that users explicitly “opt in” to obtain overdraft protection, whereas previously users received overdraft protection automatically unless they explicitly “opted out.” The former system arguably took advantage of consumer ignorance—the terms of contract that conferred overdraft protection often went unnoticed by consumers—as well as their inattention, since some effort had to be expended to decline overdraft protection. In any event, an opt-out system increases the difficulty with which users can protect themselves in their card use.

## 11.2: Financial Markets

### 11.2 Assess the significance of the three main elements of fairness in financial markets and the ethical issues introduced by new financial instruments and practices

Financial transactions typically take place in organized markets, such as stock markets, commodities markets, futures or options markets, currency markets, and the like. These markets presuppose certain moral rules and expectations of moral behavior. The most basic of these is a prohibition against fraud and manipulation, but, more generally, the rules and expectations for markets are concerned with fairness, which is often expressed as a level playing field. The playing field in financial markets can become “tilted” by many factors, including unequal information, bargaining power, and resources.

In addition to making one-time economic exchanges, participants in markets also engage in financial contracting whereby they enter into long-term relationships. These contractual relationships typically involve the assumption of fiduciary duties or obligations to act as agents, and financial markets are subject to unethical conduct when fiduciaries and agents fail in a duty. In the standard model of contracting, the terms of a contract specify the conduct

required of each party and the remedies for noncompliance. In short, there is little “wobble room” in a well-written contract. However, many contractual relationships in finance and other areas fall short of this ideal, because actual contracts are often vague, ambiguous, incomplete, or otherwise problematic. The result is uncertainty and disagreement about what constitutes ethical (as well as legal) conduct.

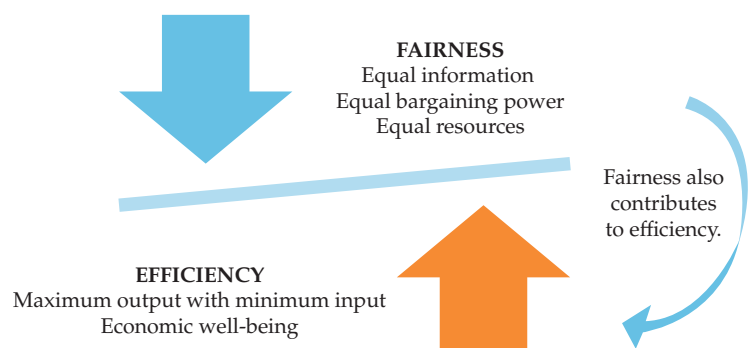
Much of the necessary regulatory framework for financial markets is provided by law. The Securities Act of 1933, the Securities Exchange Act of 1934, their many amendments, and the rules adopted by the SEC constitute the main regulatory framework for markets in securities. In addition, financial investment institutions, such as banks, mutual funds, and pension and insurance companies, are governed by industry-specific legislation. The main aim of financial market regulation is to ensure efficiency, but markets can be efficient only when people have confidence in their fairness or equity.

Efficiency is itself an ethical value because achieving the maximum output with the minimum input—which is a simple definition of efficiency—provides an abundance of goods and services and thereby promotes the general welfare. A society is generally better off when capital markets, for example, allocate the available capital to its most productive uses. People will participate in capital markets, however, only if the markets are perceived to be fair; that is, fairness has value as a means to the end of efficiency.

We also value fairness as an end in itself, and because fairness can conflict with efficiency, some choice or trade-off between the two must often be made. This unfortunate fact of life is commonly described as the equity/efficiency trade-off (see Figure 11.2). Painful choices between efficiency and fairness (or equity), or between economic and social well-being, are at the heart of many difficult public-policy decisions, but we should not lose sight of the fact that fairness contributes to efficiency even as the two conflict.

**Figure 11.2** The Fairness/Efficiency Trade-Off

Unethical conduct in financial markets is generally identified with a lack of fairness. Though fairness is necessary for an efficient market, the two goals are often conflicting.



### 11.2.1: Fairness in Markets

What constitutes fairness in financial markets?<sup>20</sup> Fairness is not a matter of preventing losses. Markets produce winners and losers, and in many cases the gain of some persons comes from an equal loss to others (although market exchanges are typically advantageous to both parties). In this respect, playing the stock market is like playing a sport: The aim is not to prevent losses but only to ensure that the game is fair. Still, there may be good reasons for seeking to protect individual investors from harm, even when the harm does not involve unfairness. Just as bean balls are forbidden in baseball (but playing hardball is okay!), so too are certain harmful practices prohibited in the financial marketplace.

The regulation of financial markets protects not only individual investors but also the general public. The stock market crash of 1929, which prompted the first securities legislation, profoundly affected the entire country. Everyone is harmed when financial markets do not fulfill their main purpose but become distorted by speculative activity or disruptive trading practices. The deleterious effect of stock market speculation is wryly expressed by John Maynard Keynes's famous quip: "When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."<sup>21</sup> More recently, the question of whether junk bonds or program trading poses risks to the stability of the financial markets has been a subject of dispute.

The possible ways in which individual investors and members of society can be treated unfairly by the operation of financial markets are many, but the main kinds of unfairness are

- fraud and manipulation,
- unequal information or information asymmetry, and
- unequal bargaining power.

**FRAUD AND MANIPULATION** One of the main purposes of securities regulation is to prevent fraudulent and manipulative practices in the sale of securities. The common-law definition of fraud is the willful misrepresentation of a material fact that causes harm to a person who reasonably relies on the misrepresentation. Section 17(a) of the 1933 Securities Act and Section 10(b) of the 1934 Securities Exchange Act both prohibit anyone involved in the buying or selling of securities from making false statements of a material fact, omitting a fact that makes a statement of material facts misleading, or engaging in any practice or scheme that would serve to defraud.

Investors—both as buyers and as sellers—are particularly vulnerable to fraud because the value of financial instruments depends almost entirely on information that is difficult to verify. Much of the important information is

in the hands of the issuing firm, and so antifraud provisions in securities law place an obligation not only on buyers and sellers of a firm's stock, for example, but also on the issuing firm. Thus, a company that fails to report bad news may be committing fraud, even though the buyer of that company's stock buys it from a previous owner who may or may not be aware of the news. Insider trading is prosecuted as a fraud under Section 10(b) of the Securities Exchange Act on the grounds that any material, nonpublic information ought to be revealed before trading.

Manipulation generally involves the buying or selling of securities for the purpose of creating a false or misleading impression about the direction of their price so as to induce other investors to buy or sell the securities. Like fraud, manipulation is designed to deceive others, but the effect is achieved by the creation of false or misleading appearances rather than by false or misleading representations.

Fraud and manipulation are addressed by mandatory disclosure regulations as well as by penalties for false and misleading statements in any information released by a firm. Mandatory disclosure regulations are justified, in part, because they promote market efficiency: Better-informed investors will make more rational investment decisions, and they will do so at lower overall cost. A further justification, however, is the prevention of fraud and manipulation under the assumption that good information drives out bad. Simply put, fraud and manipulation are more difficult to commit when investors have easy access to reliable information.

Use Table 11.1 below to review these concepts.

**Table 11.1** Fraud and Manipulation in Financial Markets

Review the following main points about fraud and manipulation. Hide the cells to quiz yourself and show them to check your answers.

<b>What is fraud?</b>	Willful misrepresentation of a material fact that causes harm to a person who reasonably relies on the misrepresentation
<b>Who is fraudulent?</b>	Anyone involved in the buying or selling of securities who makes a false or misleading statement or engages in any practice or scheme designed to defraud
<b>Who is vulnerable?</b>	Investors (buyers and sellers) are particularly vulnerable because the value of financial instruments often depends on information that is difficult to obtain or verify.
<b>How is manipulation different?</b>	Manipulation involves buying or selling securities to create a false or misleading impression about future prices, rather than just misrepresenting facts.
<b>How can both be prevented?</b>	Fraud and manipulation can be prevented by mandatory information disclosure requirements.

**UNEQUAL INFORMATION** A "level playing field" requires not only that everyone play by the same rules but also that they be equally equipped to compete. Competition

between parties with very unequal information, a situation known as *information asymmetry*, is widely regarded as unfair because the playing field is tilted in favor of the player with superior information. When people talk about equal information, however, they may mean that the parties to a trade actually possess the same information or have equal access to information.

That everyone should possess the same information is an unrealizable ideal, and actual markets are characterized by great information asymmetries. The average investor cannot hope to compete on equal terms with a market pro, and even pros often possess different information that leads them to make different investment decisions. Moreover, there are good reasons for encouraging people to acquire superior information for use in trade. Consider stock analysts and other savvy investors who spend considerable time, effort, and money to acquire information. Not only are they ordinarily entitled to use this information for their own benefit (because it represents a return on an investment), but they perform a service to everyone by ensuring that stocks are accurately priced.

**The possession of unequal information strikes us as unfair, then, only when the information has been illegitimately acquired or when its use violates some obligation to others.** One argument against insider trading, for example, holds that an insider has not acquired the information legitimately but has stolen (or “misappropriated”) information that rightly belongs to the firm. In this argument, the wrongfulness of insider trading consists not in the possession of unequal information but in violating a moral obligation not to steal or a fiduciary duty to serve others. Insider trading can also be criticized on the grounds that others do not have the same access to the information, which leads us to the second sense of equal information, namely, equal access.

The trouble with defining equal information as having equal access to information is that the notion of equal access is not absolute but relative.

Any information that one person possesses could be acquired by another with enough time, effort, and money. An ordinary investor has access to virtually all of the information that a stock analyst uses to evaluate a company’s prospects. The main difference is that the analyst has faster and easier access to information because of an investment in resources and skills. Anyone else could make the same investment and thereby gain the same access—or a person could simply “buy” the analyst’s skilled services. Therefore, accessibility is not a feature of information itself but a function of the investment that is required in order to obtain the information.

**We also hold that some information asymmetries are objectionable to the extent that they reduce efficiency.** In particular, markets are more efficient when information is

readily available, so we should seek to make information available at the lowest cost. To force people to make costly investments in information—or to suffer loss from inadequate information—is a deadweight loss to the economy if the same information could be provided at little cost. Thus, the requirement that the issuance of new securities be accompanied by a detailed prospectus, for example, is intended not only to prevent fraud through the concealment of material facts but also to make it easier for buyers to gain certain kinds of information, which benefits society as a whole.

Although efficiency and fairness both support attempts to reduce information asymmetries in financial markets, exactly what fairness or justice requires is not easy to determine.

**Example:** Consider whether a geologist who concludes after careful study that a widow’s land contains oil would be justified in buying the land without revealing what he knows.<sup>22</sup> A utilitarian could argue that without such opportunities, geologists would not search for oil, and so society as a whole is better off if such advantage taking is permitted. In addition, the widow herself, who would be deprived of a potential gain, is better off in a society that allows some exploitation of superior knowledge.

A difficult task for securities regulation, then, is drawing a line between fair and unfair advantage taking when people have unequal access to information.

**UNEQUAL BARGAINING POWER** Generally, agreements reached by arm’s-length bargaining are considered to be fair, regardless of the actual outcome. Traders who negotiate futures contracts that result in a great loss, for example, have only themselves to blame. However, the fairness of bargained agreements assumes that the parties have relatively equal bargaining power. Unequal bargaining power can result from many sources—including unequal information, which is discussed earlier—but other sources include the following factors.

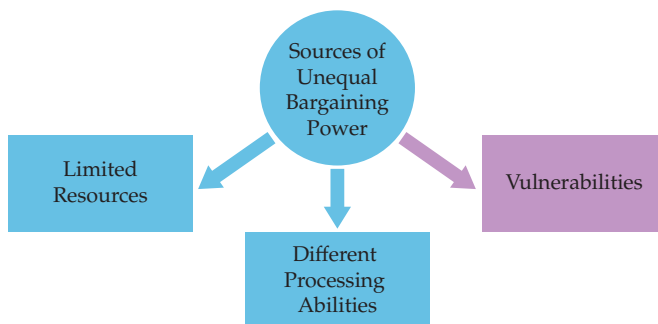
1. **Resources.** In most transactions, wealth is an advantage. The rich are better able than the poor to negotiate over almost all matters. Prices of groceries in low-income neighborhoods are generally higher than those in affluent areas, for example, because wealthier customers have more options. Similarly, large investors have greater opportunities. They can be better diversified; they can bear greater risk and thereby use higher leverage; they can gain more from arbitrage through volume trading; and they have access to investments that are closed to small investors.
2. **Processing Ability.** Even with equal access to information, people vary enormously in their ability to process information and to make informed judgments.

Unsophisticated investors are ill-advised to play the stock market and even more so to invest in markets that only professionals understand. Fraud aside, financial markets can be dangerous places for people who lack an understanding of the risks involved. Securities firms and institutional investors overcome the problem of people's limited processing ability by employing specialists in different kinds of markets, and the use of computers in program trading enables these organizations to substitute machine power for gray matter.

3. **Vulnerabilities.** Investors are only human, and human beings have many weaknesses that can be exploited. Some regulation is designed to protect people from the exploitation of their vulnerabilities. Thus, consumer protection legislation often provides for a “cooling off” period during which shoppers can cancel an impulsive purchase. The requirements that a prospectus accompany offers of securities and that investors be urged to read the prospectus carefully serve to curb impulsiveness. Margin requirements and other measures that discourage speculative investment serve to protect incautious investors from overextending themselves, as well as to protect the market from excess volatility. The legal duty of brokers and investment advisers to recommend only suitable investments and to warn adequately of the risks of any investment instrument provides a further check on people's greedy impulses.

Use Figure 11.3 to review why these factors can give one party in a negotiation an unfair advantage.

**Figure 11.3** Causes of Unequal Bargaining Power



Unequal bargaining power that arises from these factors—resources, processing ability, and vulnerabilities—is an unavoidable feature of financial markets, and exploiting such power imbalances is not always unfair. In general, the law intervenes when exploitation is unconscionable or when the harm is not easily avoided, even by sophisticated investors. The success of financial

markets depends on reasonably wide participation, and so if unequal bargaining power were permitted to drive all but the most powerful from the marketplace, then the efficiency of financial markets would be greatly impaired.

Fairness in financial markets also includes efficient prices that reasonably reflect all available information. A fundamental market principle is that the price of securities should reflect their underlying value. The mandate to ensure “fair and orderly” markets—set forth in the Securities Exchange Act of 1934—has been interpreted to authorize interventions to correct volatility or excess price swings in stock markets. Volatility that results from a mismatch of buyers and sellers is eventually self-correcting, but in the meantime, great harm may be done by inefficient pricing. Individual investors may be harmed by buying at too high a price or selling at too low a price during periods of mispricing. Volatility also affects the market by reducing investor confidence, thus driving investors away, and some argue that the loss of confidence artificially depresses stock prices. At its worst, volatility can threaten the whole financial system, as it did in the October 1987 stock market crash or the more recent “flash crash” of May 6, 2010, which resulted from a malfunctioning computer trading program.

### 11.2.2: Derivatives and HFT

The three elements of fairness in financial markets—freedom from fraud and manipulation, freedom from unequal information, and freedom from unequal bargaining power—are addressed by extensive government and industry regulation. In spite of this plethora of guidance, considerable ethical uncertainty continues to exist, due mainly to novel instruments and practices that are not covered by existing laws and rules. (This lack of coverage is exacerbated when innovations are designed merely to evade onerous existing regulations.) Recent examples of ethically problematic financial instruments include *derivatives*, some of which were central to the financial crisis that started in 2007. Other ethically problematic instruments that are not considered here are subprime mortgages and mortgage-backed securities, which were major factors in the recent financial crisis. In addition, the trading practice known as *high-frequency trading* (HFT) has occasioned great ethical concern.

**DERIVATIVES** A derivative is a financial contract or agreement between a buyer and a seller the value of which is dependent on or derived from (hence, the term “derivative”) some underlying asset (the “underlying”). The agreement in a derivative is made at some point in time and commits the parties to some future financial exchange under the terms initially agreed upon.

### There are three types of derivatives.

- In a *futures* contract, a buyer and a seller agree on the trade of, say, a bushel of wheat at some date in the future, at a price determined at the time of the agreement. Fixing the price for future delivery in advance insulates both parties from any price change in the meantime, thereby forgoing any gain from a favorable change but also protecting against any loss from an unfavorable one.
- The buyer of an *option* obtains the right, but not the obligation, to make a trade with the seller of the option at some time in the future under previously agreed upon terms. For this right, the buyer pays the seller a fee, which compensates the seller for any loss that is incurred when the option is exercised.
- In a *swap*, a borrower with a fixed-rate loan and one paying a variable rate, for example, can exchange (“swap”) obligations in order to assume different risks with regard to, in this case, interest rate changes. Agreements to swap obligations in different currencies are also often used to protect against fluctuations in exchange rates.

The purpose of most derivatives is to manage the risks of an uncertain future by protecting against adverse events—or by benefiting from expected favorable changes. With a futures contract, a farmer, for example, can gain insurance against depressed prices at harvest time, but a speculator who grows no crops can also use such contracts solely to make bets on price movements. The benefits of derivatives also include more flexibility in managing finances; for example, instead of selling stock to avoid an anticipated price decline, the holder can merely purchase an option to sell it later at a favorable price, thereby avoiding the cost of a stock sale. Alternatively, instead of buying stock that is expected to rise, an investor can merely purchase an option that can be exercised later to benefit from an increase in price.

Despite the usefulness of derivatives to manage risks, they can also create risks, especially when leverage is used to magnify potential gains and losses. Some well-publicized losses in recent years by companies and local governments led Warren Buffett to characterize derivatives as “financial weapons of mass destruction.”<sup>23</sup> Ambivalence toward derivatives is also reflected in a 2011 survey by the Chartered Financial Analyst Institute, in which derivatives were found to be the top ethical concern of this organization’s members.<sup>24</sup> The two main ethical objections to derivatives are

- first, their use merely to speculate or gamble in financial markets and,
- second, the sale of unsuitable derivatives to buyers who subsequently suffer great losses.

The noted economist Nicholas Kaldor defines speculation as “the purchase (or sale) of goods with a view to resale (re-purchase) at a later date, where the motive behind such action is the expectation of a change in the relevant prices relatively to the ruling price and not a gain accrued through their use, or any kind of transformation effected in them or their transfer between different markets.”<sup>25</sup> The key to this definition is the element of motive or intent: A farmer typically enters into a futures contract to ensure an acceptable price for the wheat he is already growing, but a speculator, who owns no wheat, is hoping merely to profit from an expected price at harvest time without engaging in any real economic production. Such speculation seems to violate the biblical injunction against reaping where one has not sown. In addition, speculation is alleged to distort prices, increase price volatility, and even lead to price gouging in times of scarcity. However, these allegations are factual claims that require supporting evidence. Moreover, the ability to engage in legitimate hedging (by farmers, for example) may depend on the willingness of others (speculators) to make pure bets.

The problem of unsuitability with derivatives is vividly illustrated by the near-bankruptcy of Jefferson County, Alabama.

### Case: Jefferson County’s Interest-Rate Swaps

In 2011, the county, whose seat is Birmingham, could no longer make payments on interest-rate swaps with a nominal value of \$5.4 billion; these swaps covered \$3.2 billion in bonds that had been issued for a troubled new sewer system. Not only did the swaps fail to provide adequate protection against interest-rate changes, but a combination of factors greatly increased the amount of the payments due. In addition, the massive fees charged by the issuing banks were considered excessive. The woes of Jefferson County were also attributable to massive government corruption—21 individuals were convicted—but the banks also contributed to the corruption, with one bank paying \$8 million in bribes to participate in the deals. Jefferson County has been described as “a ‘poster child’ for all that can go wrong when municipalities start playing with unregulated derivatives peddled by Wall Street sharpies.”<sup>26</sup>

The suitability of a derivative is a complex judgment requiring a high level of expertise. Consequently, it is easy not only to make honest mistakes but also to take advantage of user’s lack of sophistication. John Cassidy, a columnist for *The New Yorker*, said of the issuers of derivatives, “They’re called investment bankers but they’re effectively salesmen. Their job is to go out and sell the stuff that the bank is creating.”<sup>27</sup> This comment brings into question, however, the obligation of a seller to ensure the suitability of a derivative for unsophisticated but willing users—or indeed for users who are themselves engaging in speculation rather than hedging.

## WRITING PROMPT

### Unsuitable Trading Techniques

What does the Jefferson County case illustrate about the responsibility of banks in selling complex derivative products to local governments? Do the banks have any moral obligation to ensure that these products are suitable, or is it morally permissible for the banks to sell these products to local governments?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

**HIGH-FREQUENCY TRADING** High-frequency trading (HFT), also known as algorithmic trading, involves the buying and selling of securities (most commonly stocks) with the decisions being made not by human traders but by computers. The computers used for HFT are programmed to analyze vast amounts of data and to enter buy and sell orders within fractions of seconds. Firms that engage in HFT often hold positions for very short periods of time and usually close out their positions at the end of a trading day. Many HFT orders to buy and sell are not intended to result in trades but are entered merely to gain additional market information from the responses they generate. HFT now constitutes, it is estimated, between one-half and three-quarters of all stock trades.<sup>28</sup>

HFT is possible only because the crucial role of matching buyers and sellers is no longer done by a human being on the floor of a stock exchange (known as a “market maker”) but by an exchange’s computer (called a “matching engine”). The information that HFT programs utilize is not only traditional financial information about the overall economy and the companies whose stock is being traded, but also information about the order flow of other traders that is registered in exchanges’ matching engines. This information creates trading opportunities that may exist only momentarily and will be seized by the first computer to act on them. Time is so critical that trading firms seek to reduce the distance between their computers and exchanges’ matching engines by installing shorter fiber optic cables and even renting space in exchange buildings—a situation known as “co-location.” Exchanges have also allowed “flash trading,” in which some trading firms, for a fee, are allowed access to order flows a few milliseconds before other market participants. The result is a two-tier market in which HFT traders with expensive equipment and privileged access compete against their slower, low-tech human counterparts.

The widespread public concern about HFT is hampered by a pervasive lack of understanding about the practice.

What are HFT traders doing? And how are they making money?

One technique, apparently, is to gain knowledge of a buy order on one exchange and to fill it with the same stock

bought by the HFT trader more cheaply on another exchange. Some HFT firms also pay a fee to online brokers, such as E\*Trade, TD Ameritrade, and Charles Schwab, for the opportunity to fill orders at the bid price by buying the stocks more cheaply elsewhere. Although orders get filled in either scenario, the price paid by a buyer—whether it be a large institution, such as a pension fund, or an individual investor—may not be the best possible, and even a penny per share can generate considerable sums when it is collected across numerous transactions.

In addition, traders can use advance knowledge of buy and sell orders to predict movements in stock prices and trade ahead of other market participants. This use of advance knowledge has led critics to describe HFT as a computerized form of frontrunning, in which knowledge of other investors’ orders is used to trade in front of them.<sup>29</sup> Some federal and state investigators have alleged that such frontrunning constitutes a form of insider trading because it utilizes market-moving information to which the ordinary investing public has no access.<sup>30</sup>

Defenders of HFT argue that the role of intermediaries in securities trading has always been required and that HFT is merely replacing traditional market makers. Moreover, HFT serves well in this role by ensuring that orders are filled reliably and quickly at low cost with stable prices and little spread between the price bid by buyers and the price asked by sellers. In technical terms, HFT accomplishes the following tasks:

- It increases liquidity (the assurance that securities can be bought and sold).
- It improves latency (the time it takes to complete a trade).
- It reduces volatility (wide swings in prices).
- It minimizes the bid/ask spread (which reduces opportunities for gains by intermediaries).
- In times of crisis, HFT may also serve as a buyer or seller of the last resort, thereby enabling troubled investors to adjust their portfolios.

Overall, they claim, investors are well-served by HFT.

### What do you think are the main arguments against HFT?

Critics, on the other hand, contend that this market-making role is unnecessary since HFT traders are merely stepping in between buyers and sellers who would have gotten together in a few more milliseconds without incurring any extra cost. Before the advent of HFT, critics allege, low-tech markets already completed trades quickly with adequate liquidity and price stability. Furthermore, high-frequency traders have tended to withdraw from roiled markets instead of remaining and calming them, so that the practice does little to help in times of crisis. In the view of critics, HFT is like a car airbag that always works except in crashes. In addition, the computer programs used in HFT can themselves cause crises when they malfunction, as witnessed by the so-called “flash

crash” on May 6, 2010, in which the Dow Jones Industrial Average quickly dropped 9 percent, only to rebound within 30 minutes.<sup>31</sup> HFT also creates opportunities for manipulating markets, as illustrated by one firm that was fined by regulators for creating a false impression of market demand by quickly entering and cancelling large volumes of orders.<sup>32</sup>

Finally, the prospect of a two-tier market in which a few participants with expensive equipment and privileged access make gains in ways that provide little or no benefit to the economy as a whole conveys the impression that trading is rigged. *The Economist* magazine compares HFT to “allowing Formula 1 drivers onto suburban streets.”<sup>33</sup> Although any trader could, in theory, make the necessary investment in equipment and expertise, would such a market be fair to all investors? Formula 1 or stay off local roads? Other kinds of investors make a contribution not only by their willingness to invest but also by trading on the basis of fundamental analysis of securities, which plays little role in HFT. If the perception of a rigged market deters the full range of potential investors from participating, then the market will fail to fulfill its critical function of allocating capital efficiently and thereby of facilitating a prosperous economy.

## 11.3: Insider Trading

### 11.3 Summarize the two main arguments against insider trading and the challenges in applying these theories to its prevention and prosecution

Insider trading is commonly defined as trading in the securities of publicly held corporations on the basis of material, nonpublic information.

**Texas Gulf Sulphur example:** In a landmark 1968 decision, executives of Texas Gulf Sulphur Company were found guilty of insider trading for investing heavily in their own company’s stock after learning of the discovery of rich copper ore deposits in Canada.<sup>34</sup>

The principle established in the *Texas Gulf Sulphur* case is that corporate executives must refrain from trading on information that significantly affects stock price until it becomes public knowledge. The rationale for this principle is that insiders with access to nonpublic information have an unfair advantage over uninformed investors in the market. Furthermore, insiders, like the executives of Texas Gulf Sulphur, have this unfair informational advantage by virtue of their position in a company to which they owe a fiduciary duty. So in addition to acting unfairly in the market, such corporate insiders also breach a fiduciary duty to their employer by using company-owned information for their own benefit. The rule for corporate insiders is, consequently, “**Reveal or refrain!**” That is, reveal what you know to the investing public or else refrain from trading until the information is publicly known.

In addition to corporate executives, who are obviously “insiders,” the category of those who are legally prohibited from trading on material, nonpublic information are temporary or “constructive” insiders, such as lawyers, accountants, consultants, and others who have been brought inside a corporation for some period of time to provide their services. Like regular employees, they have a fiduciary duty to the companies they (temporarily) serve. However, “outsiders” who possess material, nonpublic information without any involvement in a corporation may also be barred from trading in its securities. Such traders have no fiduciary duty themselves to a company whose securities they trade, but the information they possess still belongs to the company and has been acquired due to some breach of a fiduciary duty in the course of its disclosure. The corresponding rule for outsiders is thus: “**Don’t trade on information that is disclosed in violation of a trust!**”

Among outsiders who have been charged with insider trading are the following examples.

#### “Outsiders” Charged with Insider Trading<sup>35</sup>

- A **printer** who was able to identify the targets of several takeovers from legal documents that were being prepared
- A **financial analyst** who uncovered a huge fraud at a high-flying firm and advised his clients to sell
- A **stockbroker** who was tipped off by a client who was a relative of the president of a company and who learned about the sale of the business through a chain of family gossip
- A **psychiatrist** who was treating the wife of a financier who was attempting to take over a major bank
- A **lawyer** whose firm was advising a client planning a hostile takeover
- A **hacker** who traded on information obtained by breaking into a company’s computer system

The first two traders were eventually found innocent of insider trading; the latter four were found guilty (although the stockbroker case was later reversed in part).

Both rules—“Reveal or refrain!” and “Don’t trade on information that is disclosed in violation of a trust!”—leave much room for interpretation, which could be filled by a more precise theory of insider trading.

### WRITING PROMPT

#### Innocent Outsiders

Review the actions of the printer and financial analyst who were charged with insider trading. Explain whether their actions fit the legal definition of insider trading. Regardless of the law, which actions could be considered morally objectionable?

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### 11.3.1: Theories of Insider Trading

The definition of insider trading in U.S. law, as well as the legal basis for prosecution, has evolved largely through court decisions. The main statutory grounds for prosecutions have been a general prohibition against fraud contained in Section 10(b) of the 1934 Securities Exchange Act and the corresponding SEC Rule 10b-5, which merely prohibits the use of any “device, scheme, or artifice to defraud.” The task for the courts has been to find a rationale for construing insider trading as a kind of fraud. The legal basis for prosecuting insider trading in Europe, which is of more recent origin, is The Market Abuse Directive of 2003 and the accompanying Market Abuse Regulation, both of which are still in a process of development and implementation. In contrast to U.S. law, in which insider trading is considered a kind of fraud involving the violation of a fiduciary duty, the European approach is based more on a right of equal access to information.

**FAIRNESS THEORY** The attempt in U.S. law to construe insider trading as a kind of fraud has resulted in two distinct theories, transactions and the other, property rights in information. The fairness theory holds that traders who use inside information have an unfair advantage over other investors and that, as a result, the stock market is not a level playing field. The unfairness in insider trading extends not only to the investing public but also to the company of which an insider is a member. Insider trading of the kind that occurred at Texas Gulf Sulphur involves unjust enrichment, in which the executives benefited themselves by abusing their privileged position in exploiting access to information that was denied to outsiders.

Rule for Insiders: “Reveal or refrain!”

Fairness in the stock market does not require that all traders have the same information. Indeed, trades will take place only if the buyers and sellers of a stock have different information that leads them to different conclusions about the stock’s worth. It is only fair, moreover, that a shrewd investor who has spent time and money studying the prospects of a company should be able to exploit that advantage; otherwise, there would be no incentive to seek out new information. What is objectionable about using inside information is that other traders are barred from obtaining it no matter how diligent they might be. The information is unavailable not for lack of *effort* but for lack of *access*. The insider possesses information that is inaccessible in principle to outsiders. Poker also pits card players with unequal skill and knowledge without being unfair, but a game played with a marked deck gives some players an unfair advantage over others. By analogy, then, insider trading is like playing poker with a marked deck. Another, perhaps more appropriate,

analogy is the seller of a house who fails to reveal hidden structural damage.

One principle of stock market regulation is that, as a matter of fairness, both buyers and sellers of stock should have sufficient information to make rational choices. Thus, companies must publish annual reports and disclose important developments in a timely manner.<sup>36</sup> A CEO who hides bad news from the investing public, for example, can be sued for fraud. Good news, such as an oil discovery, need not be announced until a company has time to buy the drilling rights, and so on, but to trade on that information before it is public knowledge might be rightly compared to the fraud committed by a house seller who fails to make proper disclosures.

The fairness theory applies easily to corporate insiders but is an awkward fit with outsiders. For example, the printer and the stock analyst had no relation to the corporations in question and so had no fiduciary duty to refrain from using the information that they had acquired. They had an advantage over other, less-informed investors, but was this advantage unfair?

Rule for Outsiders: “Don’t trade on information that is disclosed in violation of a trust!”

Typically, outsiders who are prosecuted for insider trading are “tipees,” individuals who are tipped off about market-moving news by insider “tippers,” who may or may not be aware of other’s knowledge. Because such outsiders have no fiduciary duty to the source of the information, it is difficult to identify any moral wrong when they use this information in making trades. Indeed, the printer and the stock analyst were found not guilty of insider trading for lack of any fiduciary duty. However, if it makes sense to bar insiders from trading on material nonpublic information, then the same reasoning applies when this information is disclosed, knowingly or not, to other parties. Otherwise, any legal consequences for insider trading law could be easily avoided merely by tipping off family and friends and by allowing *them* to make the trades.

**PROPERTY RIGHTS THEORY** The difficulty in prosecuting tipees has been addressed by the courts through the property rights theory, which is also known as the *misappropriation* theory. On this theory, the inside information is a kind of property that belongs to the source, usually the originating corporation, and an outsider who acquires it and trades on this basis has misappropriated this information—or, more bluntly, stolen it—from its rightful owner.

Fiduciary duty is still involved in the misappropriation of inside information insofar as outsiders, such as the stockbroker and the psychiatrist, who may owe no fiduciary duty to the source of the information, nevertheless knew or should have known that they were obtaining inside information indirectly from high-level executives

who did have a fiduciary duty to keep the information confidential. Consequently, they were beneficiaries of other's violation of fiduciary duty as well as recipients of information that had been misappropriated. The violation of a fiduciary duty by the tipper thus taints the information received by a tpee and makes its use in trading impermissible.

The property rights or misappropriation theory is of uncertain application. For example,

- should it be illegal for the person receiving a tip, a tpee, to trade when the source of the information is not known, or when the information itself is not known for certain to be nonpublic?
- A tipper who sells information to a tpee or otherwise gains some benefit should incur legal liability, but is there any legal offense when the tipper gains nothing in return for the tip?

In a recent controversial decision, a court has held that such cases do not constitute illegal insider trading.<sup>37</sup> The insider trading conviction of the hacker troubles many observers due to the lack of any violation of a fiduciary duty. Obtaining information from hacking is clearly theft, but did the trading on stolen information constitute fraud?<sup>38</sup>

There is wide agreement among legal scholars that the definition of insider trading crafted by the courts through case law is "seriously flawed,"<sup>39</sup> "astonishingly dysfunctional,"<sup>40</sup> and a "theoretical mess."<sup>41</sup> Some observers have proposed instead that Congress follow the European approach by writing an explicit definition into law in which there are few exceptions. The rule in Europe is simple: "If you have material, inside information, you can't trade on it, period."<sup>42</sup>

### 11.3.2: Evaluation of the Two Theories

**Fairness is of undeniable importance in securities markets, but the main value of fairness lies in its promotion of efficiency.** Without fairness, investors would be less willing to trade and would incur greater cost in trading. Overall, the market would be less efficient if insider trading were common. One trouble with such a claim is that some economists argue that the stock market would be more efficient *without* a law against insider trading.<sup>43</sup> If insider trading were legally permitted, they claim, information would be registered in the market more quickly and at less cost than the alternative of leaving the task to research by stock analysts. The main beneficiaries of a law against insider trading, critics continue, are not individual "mom-and-pop" investors but market professionals who can pick up news "on the street" and act on it quickly. Some economists argue further that a law against insider

trading preserves the illusion that there is a level playing field and that individual investors have a chance against market professionals.

These kinds of economic arguments against a legal prohibition on insider trading look only at the cost of registering information in the market and not at possible adverse consequences of legalized insider trading, which are many. Investors who perceive the stock market as an unlevel playing field may be less inclined to participate or will be forced to adopt costly defensive measures. Legalized insider trading would have an effect on the treatment of information in a firm. Employees whose interest is in information that they can use in the stock market may be less concerned with information that is useful to the employer, and the company itself might attempt to tailor its release of information for maximum benefit to insiders. More importantly, the opportunity to engage in insider trading might undermine the relation of trust that is essential for business organizations.<sup>44</sup> A prohibition on insider trading frees employees to do what they are supposed to be doing—namely, working for the interests of the corporation—not seeking ways to advance their own interests in the stock market.

The harm that legalized insider trading could do to organizations suggests that the strongest argument against legalization might be the breach of fiduciary duty that would result. Virtually everyone who could be called an "insider" has a fiduciary duty to serve the interests of the corporation and its shareholders, and the use of information that is acquired while serving as a fiduciary for personal gain is a violation of this duty. It would be a breach of professional ethics for a lawyer or an accountant to benefit personally by using information acquired in confidence from a client, and it is similarly unethical for a corporate executive to make personal use of confidential business information.

The argument that insider trading constitutes a breach of fiduciary duty accords with recent court decisions that have limited the prosecution of insider trading to true insiders who have a fiduciary duty. One drawback of this argument is that insider trading, on this argument, is no longer an offense against the market but the violation of a duty to another party. And the duty not to use information that is acquired while serving as a fiduciary prohibits more than insider trading. The same duty would be violated by a fiduciary who buys or sells property or undertakes some other business dealing on the basis of confidential information. That such breaches of fiduciary duty are wrong is evident, but the authority of the SEC to prosecute them through securities law under a mandate to prevent fraud in the market is less clear.

**Turning now to the property rights or misappropriation theory, one difficulty with it lies in determining who owns the information in question.** The main basis for

recognizing a property right in trade secrets and confidential business information is the investment that companies make in acquiring information and the competitive value that some information has. Not all insider information fits this description, however. Advance knowledge of better-than-expected earnings would be an example. Such information still has value in stock trading, even if the corporation does not use it for that purpose. For this reason, many employers prohibit the personal use of *any* information that an employee gains in the course of his or her work. This position is too broad, however, since an employee is unlikely to be accused of stealing company property by using knowledge of the next day's earning report for any purpose other than stock trading.

A second difficulty with the property rights or misappropriation theory is that if companies own certain information, they could then give their own employees permission to use it, or they could sell the information to favored investors or even trade on it themselves to buy back stock. Giving employees permission to trade on insider information could be an inexpensive form of extra compensation that further encourages employees to develop valuable information for the firm. Such an arrangement would also have some drawbacks; for example, investors might be less willing to buy the stock of a company that allowed insider trading because of the disadvantage to outsiders. What is morally objectionable about insider trading, according to its critics, though, is not the misappropriation of a company's information but the harm done to the investing public. So the violation of property rights in insider trading cannot be the sole reason for prohibiting it.

### WRITING PROMPT

#### Understanding Insider Trading

Which interpretation of insider trading seems more convincing—the fairness theory or property rights theory? What are the specific strengths and weaknesses of each theory? How might the two theories have different implications in practice?

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### 11.3.3: Recent Insider Trading Cases

The absence of a precise legal definition of insider trading reflects, in part, the diversity of forms that insider trading can take, but also the inability of any rules, no matter how well crafted, to prevent circumvention by clever traders. Insider trading is both hard to define and difficult to prevent. The government view has been that a vague law with sharp teeth provides maximum deterrence. Just how sharp these teeth can be has been illustrated by two recent cases involving the prosecution of a lawyer, James O'Hagan, and

the manager of the Galleon hedge fund, who relied on a network of informants and not a single source of information.

**THE O'Hagan DECISION** In 1997, the U.S. Supreme Court ended a decade of uncertainty over the legal definition of insider trading. The SEC has long prosecuted insider trading using the misappropriation theory, according to which an inside trader breaches a fiduciary duty by misappropriating confidential information for personal trading. In 1987, the High Court split 4–4 on an insider trading case involving a reporter for the *Wall Street Journal* and thus left standing a lower court decision that found the reporter guilty of misappropriating information.<sup>45</sup> However, the decision did not create a precedent for lack of a majority. Subsequently, lower courts rejected the misappropriation theory in a series of cases in which the alleged inside trader did not have a fiduciary duty to the corporation whose stock was traded. The principle applied was that the trading must itself constitute a breach of fiduciary duty. This principle was rejected in *U.S. v. O'Hagan*.<sup>46</sup>

#### Validation of the Misappropriation Theory

James H. O'Hagan was a partner in a Minneapolis law firm that was advising the British firm Grand Metropolitan in a hostile takeover of Minneapolis-based Pillsbury Company. O'Hagan did not work on Grand Met business but allegedly tricked a fellow partner into revealing the takeover bid. O'Hagan then reaped \$4.3 million by trading in Pillsbury stock and stock options. An appellate court ruled that O'Hagan did not engage in illegal insider trading because he had no fiduciary duty to Pillsbury, the company in whose stock he traded. Although O'Hagan misappropriated confidential information from his own law firm—to which he owed a fiduciary duty—trading on this information did not constitute a fraud against the law firm or against Grand Met. Presumably, O'Hagan would have been guilty of insider trading only if he were an insider of Pillsbury or had traded in Grand Met stock.

In a 6–3 decision, the Supreme Court reinstated the conviction of Mr. O'Hagan and affirmed the misappropriation theory. According to the decision, a person commits securities fraud when he or she “misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information.” Thus, an inside trader need not be an insider (or a temporary insider, like a lawyer) of the corporation whose stock is traded. Being an insider in Grand Met is sufficient in this case to hold that insider trading occurred. The majority opinion observed that “it makes scant sense” to hold a lawyer like O'Hagan to have violated the law “if he works for a law firm representing the target of a takeover offer, but not if he works for a law firm representing the bidder.” The crucial point is that O'Hagan was a fiduciary who misused information that had been entrusted to him. This decision would also apply to a person who receives information from an insider and who knows

that the insider source is violating a duty of confidentiality. However, a person with no fiduciary ties who receives information innocently (by overhearing a conversation, for example) would still be free to trade.

**GALLEON AND THE MOSAIC THEORY** One of the longest sentences for insider trading to date, 11 years in prison along with a \$63.8 million penalty, was imposed in October 2011 on Raj Rajaratnam, the founder and head of the Galleon Group, one of the largest and most successful hedge funds on Wall Street.<sup>47</sup> Mr. Rajaratnam, a Sri Lankan native, had been found guilty the previous May of 14 counts of securities fraud and conspiracy for an insider trading scheme that had netted the firm \$72 million in realized gains and avoided losses. Before the sentencing, 50 other people had been convicted or pleaded guilty of insider trading connected with Galleon.

The trial had been closely watched as a test of an unusual defense called the “mosaic theory,” in which the information comes not in a single tip from an insider but as tidbits of information from multiple sources. These small pieces of information are assembled, like the tiny tiles in a mosaic, along with the results of legitimate research, to provide a basis for lucrative stock trades.

### Rejection of the Mosaic Theory

The 220-page 2010 edition of the CFA Institute *Standards of Practice Handbook* for chartered financial analysts states:

The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the “mosaic theory,” financial analysts are free to act on this collection, or mosaic, of information without risking violation.

This statement makes clear that nonpublic information may be used in trading as long as the individual pieces are small and seemingly nonconsequential or nonmaterial, even when a conclusion derived from them would constitute illegal insider trading if it had been conveyed as a whole, say from a single source.

In the Galleon trial, the jury that found Mr. Rajaratnam guilty of insider trading was apparently persuaded by prosecution arguments about the importance of two further issues.

- First, were even small pieces of information disclosed by insiders in violation of a fiduciary duty to their own employer?
- Second, had the network of informants been developed into an unprecedented large-scale effort to collect nonpublic information?

The wiretap recordings that were played in court revealed that Mr. Rajaratnam had cultivated many inside

sources who had access to confidential information in their place of employment. Disclosing such information, whether it was material or not, would ordinarily be a violation of an employee’s fiduciary duty. Furthermore, the number of informants that Mr. Rajaratnam had cultivated and the frequency and diligence with which they reported to him were unprecedented by Wall Street standards. Galleon had become a veritable mosaic factory.

Prosecutors in the Galleon case had also become concerned about the development of expert network firms, which offered, for a fee, to connect users of information with knowledgeable individuals. With huge databases of experts, these firms, also known as “alternative research providers,” were able to arrange telephone conversations between clients and experts on almost any subject. Although such firms offered their services mainly to technology clients, expert network firms that catered mainly to investors had become, by 2008, a \$433 million business.<sup>48</sup> Following successful prosecutions of some individuals for illegal disclosure of information, the whole expert network industry was forced to be more diligent in enforcing standards and procedures that safeguarded confidentiality. As a result of this increased diligence, the industry has not only contracted but also changed its focus. At Mr. Rajaratnam’s sentencing, the presiding judge asserted his aggressive efforts to get an edge in the market “reflect the virus in our business culture that needs to be eradicated.”

## WRITING PROMPT

### Future Insider Trades

Explain whether the rejection of the mosaic theory in the Galleon decision threatens the legitimacy of diligent securities analysis. What precautions might securities analysts take to avoid the risk of engaging in insider trading?

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## 11.4: Hostile Takeovers

### 11.4 Analyze the ethical issues raised by various hostile takeover tactics and what they suggest about the rights and fiduciary duties of officers and directors

#### Case: Pacific Lumber Company

Since its founding in the nineteenth century, Pacific Lumber Company had been a model employer and a good corporate citizen. As a logger of giant redwoods in northern California, this family-managed company had long followed a policy of perpetual sustainable yield. Cutting was limited to selected mature trees, which were removed without disturbing the forests, so that younger trees could grow to the same size. Employees—many from families who had worked at Pacific Lumber for several generations—received generous benefits,

including an overfunded company-sponsored pension plan. With strong earnings and virtually no debt, Pacific Lumber seemed well-positioned to survive any challenge.

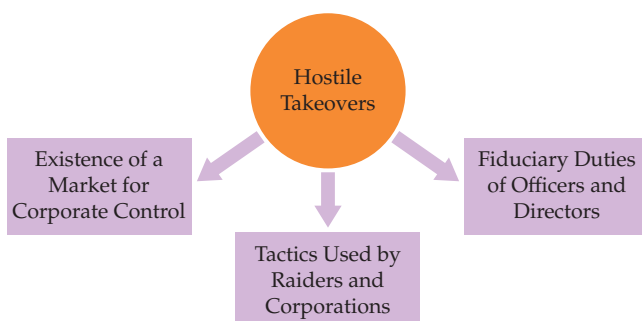
However, the company fell prey to a hostile takeover. In 1986, financier Charles Hurwitz and his Houston-based firm Maxxam, Inc., mounted a successful \$900 million leveraged buyout of Pacific Lumber. By offering \$40 per share for stock that had been trading at \$29, Hurwitz gained majority control. The takeover was financed with more risky but higher-paying junk bonds issued by Drexel Burnham Lambert under the direction of Michael Milken, the junk-bond king. Hurwitz expected to pare down the debt by aggressive clear-cutting of the ancient stands of redwoods that Pacific Lumber had protected and by raiding the company's overfunded pension plan.

Using \$37.3 million of the \$97 million that Pacific Lumber had set aside for its pension obligations, Maxxam purchased annuities for all employees and retirees and applied more than \$55 million of the remainder toward reducing the company's new debt. The annuities were purchased from First Executive Corporation, a company that Hurwitz controlled. First Executive was also Drexel's biggest junk-bond customer, and the company purchased one-third of the debt incurred in the takeover of Pacific Lumber. After the collapse of the junk-bond market, First Executive failed in 1991 and was taken over by the state of California in a move that halted pension payments to Pacific Lumber retirees. Subsequently, Charles Hurwitz and Maxxam were mired in lawsuits by former stockholders, retirees, and environmentalists.

Hostile takeovers—which are acquisitions opposed by the management of the target corporation—appear to violate the accepted rules for corporate change. Peter Drucker observed that the hostile takeover “deeply offends the sense of justice of a great many Americans.”<sup>49</sup> An oil industry CEO charged that such activity “is in total disregard of those inherent foundations which are the heart and soul of the American free enterprise system.”<sup>50</sup> Many economists—most notably Michael C. Jensen—defend hostile takeovers on the grounds that they bring about needed changes that cannot be achieved by the usual means.<sup>51</sup>

The ethical questions in hostile takeovers are three-fold, as shown in Figure 11.4.

**Figure 11.4** Ethical Issues with Hostile Takeovers



- First, should hostile takeovers be permitted at all? Insofar as hostile takeovers are conducted in a market through the buying and selling of stocks, there exists a “market for corporate control.” So the question can be expressed in the form, should there be a market for corporate control? Or, should change-of-control decisions be made in some other fashion?
- Second, ethical issues arise in the various tactics that have been used by raiders in launching attacks as well as by target corporations in defending themselves. Some of these tactics are criticized on the grounds that they unfairly favor the raiders or incumbent management, often at the expense of shareholders.
- Third, hostile takeovers raise important issues about the fiduciary duties of officers and directors in their responses to takeover bids. In particular, what should directors do when an offer that shareholders want to accept is not in the best interests of the corporation itself? Do they have a right, indeed a responsibility, to prevent a change of control?

### WRITING PROMPT

#### Ethical Framework for Hostile Takeovers

In view of Maxxam's takeover of Pacific Lumber, do you believe that hostile takeovers are morally wrong, or could they be morally permissible or even desirable in certain circumstances? What do you think is the most important ethical objection to hostile takeovers? Explain your reasoning.

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## 11.4.1: Market for Corporate Control

Defenders of hostile takeovers contend that corporations become takeover targets when incumbent management is unable or unwilling to take steps that increase shareholder value. The raiders' willingness to pay a premium for the stock reflects a belief that the company is not achieving its full potential under the current management. “Let us take over,” the raiders say, “and the company will be worth what we are offering.” Because shareholders typically find it difficult to replace the current managers through the voting process, hostile takeovers are an important means for shareholders to increase the value of their investment by changing the management team. Although restructurings of all kinds cause some hardships to employees, communities, and other groups, society as a whole benefits from the increased productivity of better-run companies.

Just the threat of a takeover serves as an important check on management, and without this constant spur, defenders argue, managers would have less incentive to secure full value for the shareholders. With regard to the

market for corporate control, defenders hold that shareholders are, and ought to be, the ultimate arbiters of who manages the corporation. If the shareholders have a right to replace the CEO, why should it matter when or how shareholders bought the stock? A raider who bought the stock yesterday has the same rights as a shareholder of long standing. Any steps to restrict hostile takeovers, the defenders argue, would entail an unjustified reduction of shareholders' rights.

Critics of hostile takeovers challenge the benefits and emphasize the harms. Targets of successful raids are sometimes broken up and sold off piecemeal or downsized and folded into the acquiring company. In the process, people are thrown out of work and communities lose their economic base. Takeovers generally saddle companies with debt loads that limit their options and expose them to greater risk in the event of a downturn. Critics also charge that companies are forced to defend themselves by managing for immediate results and adopting costly defensive measures.

The debate over hostile takeovers revolves largely around the question of whether they are good or bad for the American economy. This is a question for economic analysis, and the evidence, on the whole, is that takeovers generally increase the value of both the acquired and the acquiring corporation.<sup>52</sup> However, there is little evidence that newly merged or acquired firms outperform industry averages in the long run.<sup>53</sup> The effect on the economy aside, the benefit of hostile takeovers must be viewed with some caution.

**First, not all takeover targets are underperforming businesses with poor management.** Other factors can make a company a takeover target. The "bust-up" takeover operates on the premise that a company is worth more sold off in parts than retained as a whole. Large cash reserves, expensive research programs, and other sources of savings enable raiders to finance a takeover with the company's own assets. The availability of junk-bond financing during the 1980s permitted highly leveraged buyouts with levels of debt that many considered to be unhealthy for the economy. Finally, costly commitments to stakeholder groups can be tapped to finance a takeover. Thus, Pacific Lumber's pension plan and cutting policy constituted commitments to employees and environmentalists, respectively. Both commitments were implicit contracts that had arguably benefited shareholders in the past but that could be broken now with impunity.

**Second, some of the apparent wealth that takeovers create may result from accounting and tax rules that benefit shareholders but create no new wealth.** For example, the tax code favors debt over equity by allowing a deduction for interest payments on debt while taxing corporate profits. Rules on depreciation and capital gains may result in tax savings from asset sales following a takeover. Thus, taxpayers provide an indirect subsidy in the financing of takeovers. Some takeovers result in direct losses to other parties. Among the losers in hostile takeovers are bondholders,

whose formerly secure, investment-grade bonds are sometimes downgraded to speculative, junk-bond status.

## 11.4.2: Takeover Tactics

In a typical hostile takeover, an insurgent group—often called a "raider"—makes a *tender offer* to buy a controlling block of stock in a target corporation from its present shareholders. The offered price generally involves a premium, which is an amount in excess of the current trading price. If enough shareholders tender their shares in response to the offer, the insurgents gain control. In the usual course of events, the raiders replace the incumbent management team and proceed to make substantial changes in the company. In some instances, a tender offer is made directly to the shareholders, but in others, the cooperation of management is required.

The officers and directors of firms have a fiduciary duty to consider a tender offer in good faith. If they believe that a takeover is not in the best interests of the shareholders, then they have a right, even a duty, to fight the offer with all available means.

Corporations have many resources for defending against hostile takeovers. These tactics—collectively called "shark repellents"—include the following, which are defined in Table 11.2:

- poison pills,
- white knights,

**Table 11.2** Defensive Measures against Hostile Takeovers

Read the descriptions of the various ways corporations can defend themselves from a hostile takeover, and note the term for each tactic. Then hide the cells in the table to quiz yourself.

Terms	Takeover Defenses
<b>Crown Jewel Option</b>	A form of lockup in which an option on a target's most valuable assets (crown jewels) is offered to a friendly firm in the event of a hostile takeover.
<b>Golden Parachute</b>	A part of the employment contract with a top executive that provides for additional compensation in the event that the executive departs voluntarily or involuntarily after a takeover.
<b>Greenmail</b>	The repurchase by a target of an unwelcome suitor's stock at a premium in order to end an attempted hostile takeover.
<b>Lockup Option</b>	An option given to a friendly firm to acquire certain assets in the event of a hostile takeover. Usually, the assets are crucial for the financing of a takeover.
<b>Pac-Man Defense</b>	A defense (named after the popular video game) in which the target makes a counteroffer to acquire the unwelcome suitor.
<b>Poison Pill</b>	A general term for any device that raises the price of a target's stock in the event of a takeover. A common form of poison pill is the issuance of a new class of preferred stock that shareholders have a right to redeem at a premium after a takeover.
<b>Shark Repellent</b>	A general term for all takeover defenses.
<b>White Knight</b>	A friendly suitor who makes an offer for a target in order to avoid a takeover by an unwelcome suitor.

- lockups,
- crown jewel options,
- the Pac-Man defense,
- golden parachutes, and
- greenmail.

Some of the defensive measures (e.g., poison pills and golden parachutes) are usually adopted in advance of any takeover bid, while others (white knights and greenmail) are customarily employed in the course of fighting an unwelcome offer. Many states have adopted so-called anti-takeover statutes that further protect incumbent management against raiders. Because of shark repellents and antitakeover statutes, a merger or acquisition is virtually impossible to conduct today without the cooperation of the board of directors of the target corporation.

All takeover tactics raise important ethical issues, but three, in particular, have elicited great concern. These are unregulated tender offers, golden parachutes, and greenmail.

**TENDER OFFERS** Ethical concern about the tactics of takeovers has focused primarily on the defenses of target companies, but unregulated tender offers are also potentially abusive. Before 1968, takeovers were sometimes attempted by a so-called “Saturday night special,” in which a tender offer was made after the close of the market on Friday and set to expire on Monday morning. The “Saturday night special” was considered to be coercive because shareholders had to decide quickly whether to tender their shares, with little information.<sup>54</sup> Shareholders would generally welcome an opportunity to sell stock that trades at \$10 a share on a Friday afternoon for, say, \$15. If, on Monday morning, however, the stock sells for \$20 a share, then the shareholders who tendered over the weekend gained \$5 but lost the opportunity to gain \$10. With more information, shareholders might conclude that \$15 or even \$20 was an inadequate price and that they would be better off holding on to their shares—perhaps in anticipation of an even better offer.

Partial offers for only a certain number or percentage of shares and two-tier offers can also be coercive. In a two-tier offer, one price is offered for, say, 51 percent of the shares and a lower price is offered for the remainder. Both offers force shareholders to make a decision without knowing which price they will receive for their shares or indeed whether their shares will even be bought. Thus, tender offers can be structured in such a way that shareholders are stampeded into tendering quickly lest they lose the opportunity. The payment that is offered may include securities—such as shares of the acquiring corporation or a new merged entity—and the value of these securities may be difficult to determine. Without adequate information, shareholders may not be able to judge

whether a \$15-per-share noncash offer, for example, is fairly priced.

Congress addressed these problems with tender offers in 1968 with the passage of the Williams Act. The guiding principle of the Williams Act is that shareholders have a right to make important investment decisions in an orderly manner and with adequate information. They should not be stampeded into tendering for fear of losing the opportunity, or forced to decide in ignorance.

- Under Section 14(d) of the Williams Act, a tender offer must be accompanied by a statement detailing the bidder’s identity, the nature of the funding, and plans for restructuring the takeover target.
- A tender offer must be open for 20 business days, in order to allow shareholders sufficient time to make a decision, and tendering shareholders have 15 days in which to change their minds—thereby permitting them to accept a better offer should one be made.

The Williams Act deals with partial and two-tier offers by requiring proration. Thus, if more shares are tendered than the bidder has offered to buy, then the same percentage of each shareholder’s tendered stock must be purchased. Proration ensures the equal treatment of shareholders and removes the pressure on shareholders to tender early.

**GOLDEN PARACHUTES** At the height of takeover activities in the 1980s, between one-quarter and one-half of major American corporations provided their top executives with an unusual form of protection—golden parachutes.<sup>55</sup> A golden parachute is a provision in a manager’s employment contract for compensation—usually, a cash settlement equal to several years’ salary—for the loss of a job following a takeover. In general, golden parachutes are distinct from severance packages because they become effective only in the event of a change of control and are usually limited to the CEO and a small number of other officers and executives.

The most common argument for golden parachutes is that they reduce a potential conflict of interest. Managers who might lose their jobs in the event of a takeover cannot be expected to evaluate a takeover bid objectively. Michael C. Jensen observes, “It makes no sense to hire a realtor to sell your house and then penalize your agent for doing so.”<sup>56</sup> A golden parachute protects managers’ futures, no matter the outcome, and thus frees them to consider only the best interests of the shareholders. In addition, golden parachutes enable corporations to attract and retain desirable executives because they provide protection against events that are largely beyond managers’ control. Without this protection, a recruit may be reluctant to accept a position with a potential takeover target, or a manager might leave a threatened company in anticipation of a takeover bid.

Critics argue, first, that golden parachutes merely entrench incumbent managers by raising the price that raiders would have to pay. In this respect, golden parachutes are like poison pills; they create costly new obligations in the event of a change of control. All such defensive measures are legitimate if they are approved by the shareholders, but golden parachutes, critics complain, are often secured by executives from compliant boards of directors that they control. If golden parachutes are in the shareholders' interests, then executives should be willing to obtain shareholder approval. Otherwise, they appear to be self-serving defensive measures that violate a duty to serve the shareholders.

Second, some critics object to the idea of providing additional incentives to do what they are being paid to do anyway.<sup>57</sup> Philip L. Cochran and Steven L. Wartick observe that managers are already paid to maximize shareholder wealth. "To provide additional compensation in order to get managers to objectively evaluate takeover offers is tantamount to management extortion of the shareholders."<sup>58</sup> One experienced director finds it "outrageous" that executives should be paid after they leave a company. Peter G. Scotese writes, "Why reward an executive so generously at the moment his or her contribution to the company ceases? The approach flies in the face of the American work ethic, which is based on raises or increments related to the buildup of seniority and merit."<sup>59</sup>

The principle for justifying golden parachutes is clear, even if its application is not.

The justification for all forms of executive compensation is to provide incentives for acting in the shareholders' interests.

If golden parachutes are too generous, they entrench management by making the price of a takeover prohibitive—or else they motivate managers to support a takeover against the interests of shareholders. In either case, the managers enrich themselves at the shareholders' expense. The key is to develop a compensation package with just the right incentives, which, as Michael Jensen notes, will depend on the particular case.<sup>60</sup>

**GREENMAIL** Unsuccessful raiders do not always go away empty-handed. Because of the price rise that follows an announced takeover bid, raiders are often able to sell their holdings at a tidy profit. In some instances, target corporations have repelled unwelcome assaults by buying back the raiders' shares at a premium.

**Example:** After the financier Saul Steinberg accumulated more than 11 percent of Walt Disney Productions in 1984, the Disney board agreed to pay \$77.50 per share, a total of \$325.3 million, for stock that Steinberg had purchased at an average price of \$63.25. As a reward for ending his run at Disney,

Steinberg pocketed nearly \$60 million. This episode and many like it have been widely criticized as greenmail.

The play on the word "blackmail" suggests that there is something corrupt about offering or accepting greenmail. A more precise term that avoids this bias is *control repurchase*. A control repurchase may be defined as a "privately negotiated stock repurchase from an outside shareholder, at a premium over the market price, made for the purpose of avoiding a battle for control of the company making the repurchase."<sup>61</sup> Although control repurchases are legal, many people think that there ought to be a law prohibiting them. So we need to ask the question:

Why are control repurchases considered to be unethical?

There are three main ethical objections to control repurchases.<sup>62</sup>

**First, control repurchases are negotiated with one set of shareholders, who receive an offer that is not extended to everyone else.** This is a violation, some say, of the principle that all shareholders should be treated equally. The same offer should be made to all shareholders—or none. To buy back the stock of raiders for a premium is unfair to other shareholders.

This argument is easily dismissed. Managers have an obligation to treat all shareholders according to their rights under the charter and bylaws of the corporation and the relevant corporate law. This means one share, one vote at meetings, and the same dividend for each share. There is no obligation for managers to treat shareholders equally otherwise. Moreover, paying a premium for the repurchase of stock is a use of corporate assets that presumably brings some return to the shareholders, and the job of managers is to put all corporate assets to their most productive use.

**Example:** If the \$60 million that Disney paid to Saul Steinberg brings higher returns to the shareholders than any other investment, then the managers have an obligation to all shareholders to treat this one shareholder differently.

**Second, control repurchases are criticized as a breach of the fiduciary duty of management to serve the shareholders' interests.** Managers have a strong interest in maintaining their own jobs, but their fiduciary duty to shareholders requires them to disregard this interest in all matters involving corporate assets, which properly belong to the shareholders.

Therefore, if managers use shareholders' money to pay raiders to go away merely to save their own jobs, they have clearly violated their fiduciary duty. However, this may not be the intent of managers in all cases of greenmail. Managers of target corporations may judge that an offer is not in the best interests of shareholders and that the best defensive tactic is a repurchase of the raiders' shares.



**Example:** With \$60 million, Disney might have made another movie that would bring a certain return. However, Disney executives might also have calculated that the costs to the company of continuing to fight Saul Steinberg—or allowing him to gain control—would outweigh this return. If so, then the \$60 million that Disney paid in greenmail is shareholder money well spent. So there is no reason to believe that greenmail or control repurchases necessarily involve a breach of fiduciary duty.

**Third, some critics object to greenmail or control repurchases on the grounds that the payments invite pseudobidders who have no intention of taking control and mount a raid merely for the profit.**<sup>63</sup> The ethical wrong, according to this objection, lies with the raiders' conduct, although management may be complicitous in facilitating it. At a minimum, pseudobidders are engaging in unproductive economic activity, which benefits no one but the raiders themselves; at their worst, pseudobidders are extorting corporations by threatening some harm unless the payments are made.

Is pseudobidding for the purpose of getting greenmail a serious problem? The effectiveness of pseudobidding depends on the credibility of the threatened takeover. No raider can pose a credible threat unless an opportunity exists to increase the return to shareholders. Therefore, the situations in which pseudobidders are likely to emerge are quite limited. Even if a pseudobidder or a genuine raider is paid to go away, that person has pointed out some problem with the incumbent management and paved the way for change. Unsuccessful raiders who accept greenmail may still provide a service for everyone.<sup>64</sup>

## WRITING PROMPT

### Control Repurchase?

In your opinion, should control repurchases (or greenmail) be outlawed, or should corporations and shareholders continue to have a right to conduct this type of transaction? Explain.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

### 11.4.3: Role of Directors

In 1989, Paramount Communications made a tender offer for all outstanding stock in Time Incorporated. Many Time shareholders were keen to accept the all-cash, \$175-per-share bid (later raised to \$200 per share), which represented about a 40 percent premium over the previous trading price of Time stock. However, the board of directors refused to submit the Paramount offer to the shareholders.

Time and Warner Communications, Inc., had been preparing to merge, and the Time directors believed that a Time-Warner merger would produce greater value for the shareholders than an acquisition by Paramount. Disgruntled Time shareholders joined Paramount in a suit that charged the directors with a failure to act in the shareholders' interests.

This case raises two critical issues.

- First, who has the right to determine the value of a corporation in a merger or acquisition? Is this a job for the board of directors and their investment banking firm advisors? Both boards and their advisors have superior information about a company's current financial status and future prospects, but they also have a vested interest in preserving the status quo. Should the task of evaluation be left to the shareholders, whose interests are the ultimate arbiter but whose knowledge is often lacking? Some of the shareholders are professional arbitrageurs, who are looking merely for a quick buck.
- Second, does the interest of the shareholders lie with quick, short-term gain or with the viability of the company in the long run? Acceptance of the Paramount offer would maximize the immediate stock price for Time shareholders but upset the long-term strategic plan that the board had developed.

The Delaware State Supreme Court decision in *Paramount Communications, Inc. v. Time, Inc.* addressed both issues by ruling that the Time board of directors had a right to take a long-term perspective in evaluating a takeover bid and had no obligation to submit the Paramount proposal to the shareholders.<sup>65</sup> The court recognized that increasing shareholder value in the long run involves a consideration of interests besides those of current shareholders, including other corporate constituencies, such as employees, customers, and local communities. One concern of the Time directors was to preserve the "culture" of *Time* magazine because of the importance of editorial integrity to the magazine's readers and journalistic staff.

The *Paramount* decision is an example of a so-called "other constituency statute." A majority of states have now adopted (either by judicial or by legislative action) laws that permit (and, in a few states, require) the board of directors to consider the impact of a takeover on a broad range of nonshareholder constituencies.<sup>66</sup> Other constituency statutes reflect a judgment by judges and legislators that legitimate nonshareholder interests are harmed by takeovers and that directors faced with a takeover do not owe allegiance solely to the current shareholders.<sup>67</sup> As a result of other constituency statutes, decisions about the future of corporations depend more on calm deliberations in boardrooms and less on the buying and selling of shares in a noisy marketplace.

## Conclusion: Ethics in Finance

Ethical issues in finance are important because they bear on our financial well-being. Ethical misconduct, whether it be by individuals acting alone or by financial institutions, has the potential to rob people of their life savings. Because so much money is involved in financial dealings, there must be well-developed and effective safeguards in place to ensure personal and organizational ethics. Although the law governs much financial activity, strong emphasis must be placed on the integrity of finance professionals and on ethical leadership in our financial institutions. Some of the principles in finance ethics are common to other aspects of business, especially the duties of fiduciaries and fairness in sales practices and securities markets. However, such activities as insider trading and hostile takeovers raise unique issues that require special consideration.

### End-of-Chapter Case Studies

This chapter concludes with four case studies.

Because of the large rewards, the temptation to engage in wrongdoing is perhaps stronger in finance than in any other area of business. A mutual fund, Strong Capital Management, was destroyed when its founder engaged in practices that the fund prohibited for its own investors. The attractive “deal” that now-defunct Enron brought to bankers at Merrill Lynch (“Merrill Lynch and the Nigerian Barge Deal”) came with abundant “red flags” that were ignored. A key issue in this case is the responsibility, if any, of a bank when faced with evidence that a client is engaging in fraud. The law on insider trading has been shaped by a few high-profile prosecutions, and the most prominent of these in recent years was the widely publicized conviction and imprisonment of a homemaker celebrity (“Martha Stewart: Insider Trader?”). Like insider trading, hostile takeovers receive prominent coverage in the popular press. The title of one book, *Barbarians at the Gate*, captures the public’s fascination with epic takeover battles. “Oracle’s Hostile Bid for PeopleSoft” focuses on the ethics of hostile takeovers generally, as well as the ethical responsibility of each side in the actual conduct of a fierce takeover battle.

### Case: SCM Mutual Funds

When Richard S. Strong founded Strong Capital Management (SCM) in 1974, he wanted it to be “the Nordstrom’s of the financial industry,” believing that this store provided the very best customer service.<sup>68</sup> With this goal in

mind, he built SCM into an investment company that by 2004 managed \$33.8 billion in mutual fund and pension investments. In that year, though, SCM and Richard Strong came under scrutiny by the Securities and Exchange Commission (SEC) and the New York Attorney General for permitting market timing—not only by an outside investor but by Mr. Strong himself.

### Market Timing

Although stocks are difficult to predict, some investors make money by market timing, which is selling stocks within a few days of buying. Market timers are able to exploit inefficiencies in the market that occur when new publicly available information has not yet been reflected in stock prices. Such inefficient or “stale” prices are especially common with foreign stocks because of the large time difference between markets. Mutual funds are attractive to market timers because, unlike trades of individual stocks, which incur a broker’s fee, many mutual funds charge little or nothing to put money in and take it out since they receive their return from a management fee on the amount invested.

Rapid in-and-out trading (called “round trips”) hurts long-term mutual fund investors in several ways. For one, if a fund rises from the day before, when the market timer’s investment was made, and the trader cashes out quickly, the effect is to dilute the return to the other investors in a fund. If the market timer’s infusion of cash has not yet been invested in stocks, the earnings of the fund are due entirely to the money provided by the other investors. The market timer thus contributes nothing to the holdings that generate a fund’s earnings, and yet by putting millions of dollars into a fund for a day or two, the market timer gets a portion of that return. In addition, large inflows and outflows add trading and overhead costs, and if a fund manager has to sell stocks when a market timer withdraws funds, this could trigger taxable capital gains for all fund investors.

Market timing is not illegal, but most mutual funds discourage or prohibit the practice because of the harm to long-term investors. SCM, like most mutual fund companies, encouraged long-term holding of five years or more and advised that market timing does not work. Beginning in 1997, SCM warned shareholders that frequent traders could be banned: “Since an excessive number of exchanges may be detrimental to the Funds, each Fund reserves the right to discontinue the exchange privilege of any shareholder who makes more than five exchanges in a year or three exchanges in a calendar quarter.” Like most other

mutual fund companies, SCM also had “timing police,” who monitored trading activity for frequent activity, and from 1998 through 2003, hundreds of market timers were identified and barred from investing in Strong funds. When it was discovered that some SCM employees were market timing in their own accounts, the company issued a clear directive that the Strong funds were not to be used for short-term trading and that violators could have their trading privileges restricted.

## Company Policy

Any activity by SCM employees that would harm fund shareholders was also prohibited by the company’s code of ethics, which was distributed to all employees. In his introduction to the code, Richard Strong summed up the “three most important principles” for dealing with clients:

- You must deal with our clients fairly and in good faith;
- You must never put the interests of our firm ahead of the interests of our clients; and
- You must never compromise your personal ethics or integrity, or give the appearance that you may have done so.

Moreover, as chairman and chief investment officer of SCM<sup>69</sup> and as chairman of the board of directors of the 27 investment companies that managed the 71 SCM mutual funds,<sup>70</sup> Richard Strong had a fiduciary duty to serve the interests of all shareholders in the SCM family of funds. A fiduciary duty prohibits a person in a position of trust from gaining a benefit at the expense of those to whom the duty is owed.

## The Violations

Despite the company’s policy on market timing, the code of ethics, and a fiduciary duty, Richard Strong engaged in market timing in SCM mutual funds, making 1,400 quick trades between 1998 and 2003, including 22 round trips in 1998 in a fund for which he was also a portfolio manager. In 2000, SCM’s timing police detected the chairman’s trading activity, and the general counsel spoke to him, noting that his trading was inconsistent with the company’s stated position on market timing and its treatment of other market timers. After agreeing to quit market timing, he increased his activity, making a record 510 trades in 2001. In total, he netted \$1.8 million and obtained higher returns than ordinary investors in the same SCM funds.

In late 2002, Mr. Strong was presented with another opportunity. Canary Capital, a hedge fund headed by Edward J. Stern, sought permission to make market-timing trades in SCM funds. In return, Canary would make large investments in other SCM funds, including SCM’s own hedge fund. Between 2000 and 2003, market timing in

mutual funds and also “late trading”—an illegal activity in which traders were permitted to place orders after the official 4:00 P.M. close of the market—became epidemic, and Canary was one of the biggest operators. An SEC survey of the 88 largest fund companies found that half admitted to allowing market timers in their funds.<sup>71</sup> By one estimate, market timing during this period cost long-term mutual fund investors \$5 billion a year, which reduced the return to other investors by 1 percentage point.<sup>72</sup>

Hedge funds like Canary sought an agreement (called a “capacity” arrangement) to make a certain number of trades involving an agreed-upon amount of money during a fixed period of time. In return, the hedge fund would turn over a large amount of money (called a “sticky asset”) to be managed by the investment company. Canary had obtained a capacity arrangement with a large number of investment companies and banks, including Pimco Advisors, Alliance Capital Management, Invesco, Bank One, and, most famously, Bank of America, which provided Canary with its own computer terminal to place late trades. In addition, Canary gained access to the list of stock holdings in these companies’ mutual funds. This information, which was provided to other investors only twice a year, was essential for determining how a fund would perform.

In 2001 and 2002, Canary was making so much money and attracting so many new investors that it was finding it more difficult to obtain sufficient “capacity,” that is, mutual funds that would permit market-timing trades. This success led to the firm’s downfall. In an effort to get the attention of Goldman Sachs, Canary hired a former employee, Noreen Harrington. Goldman Sachs was uninterested, and Harrington left in dismay when she discovered how Canary’s money was made. She was not intending to blow the whistle until her sister complained about how much money she was losing in her mutual fund and how she would never be able to retire. “I didn’t think about this from the bottom up until then,” Harrington said.<sup>73</sup> A telephone call to the New York State Attorney General’s office started the investigation that eventually led to Richard Strong.

### SHARED WRITING: SCM MUTUAL FUNDS

What elements of unfairness did Richard Strong and Canary capitalize on with their market timing strategies: fraud, manipulation, unequal information, or unequal bargaining power? Were long-term mutual fund investors the only victims, or was the overall stability and health of the financial market affected? Review and comment on at least two classmates’ responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Merrill Lynch and the Nigerian Barge Deal

The investment bankers at Merrill Lynch were considering an unusual offer from the treasurer at Enron.<sup>74</sup> Daniel Bayly, the global head of the investment banking division at Merrill Lynch, had been approached by Jeffrey McMahon at Enron about the purchase of three electrical generating barges in the waters of Nigeria. Enron was coming to the end of 1999 and desperately needed to book more revenue to keep up the company's high-flying stock price, and this deal would earn Enron a much-needed \$12 million profit.

Merrill Lynch was not in the electrical generating business, but the deal did not require the investment banking giant to operate the barges, which, in any event, were not yet up and running. The plan, as conceived by Enron executives, was for Merrill Lynch to purchase the three barges for \$28 million. Three-quarters of this amount, \$21 million, would be loaned to Merrill Lynch by Enron, so that Merrill Lynch would need to put up only \$7 million of the purchase price. In return, Enron would promise to find a buyer for the barges or else buy them back within six months with a guaranteed return of 15 percent on Merrill Lynch's \$7 million outlay. Ordinarily, a return of this size would require the assumption of considerable risk, but Enron was offering the Merrill Lynch bankers an outsized, risk-free return—almost too good an offer to turn down. All that was needed was for Daniel Bayly to sign off on the deal.

### Concerns about the Deal

Mr. Bayly had some reasons for concern. If Enron was committed to buying back the barges with no risk for Merrill, then was this a true sale? Would Merrill Lynch be the real owner during this time? If not, then the "sale" would be more a disguised loan. Such a loan should be recorded in Enron's books as debt, but the purpose of the deal was clearly to enable Enron to report \$12 million in revenue. Enron might thus be engaging in accounting fraud, but, if so, was this Merrill Lynch's responsibility? Enron did not promise to repurchase the barges itself but only to ensure that a buyer would be found. If that buyer were a third party, then the transaction would be a legitimate sale. In the meantime, Merrill Lynch would be providing what is called "bridge equity," which is a short-term investment that is used until a long-term investor can be found. Enron had, in fact, been negotiating to sell the barges to a Japanese firm, the Marubeni Corporation. The negotiations were not proceeding fast enough to complete a sale before the end of the year, but perhaps a sale could be concluded within six months' time.

The repurchase could also be made by one of the many off-balance-sheet partnerships, or special purpose entities (SPEs), that Enron had set up. One partnership, called LJM2, which was controlled by Enron CFO Andrew Fastow, had

engaged in a number of rapid sales and repurchases that created revenues for Enron and kept debt off its balance sheet. If the commitment to buy back the barges came from Mr. Fastow on behalf of the LJM2, then it would not be coming from Enron itself. Moreover, the Enron plan did not call for Merrill Lynch to directly buy the barges. Instead, an SPE would be created that would be funded with \$21 million from Enron and \$7 million from Merrill. Accounting standards permitted such a shell entity to be off Enron's balance sheet if it had 3 percent outside ownership, which would be provided by Merrill's investment. Since Enron would still have control of the SPE, the effect would be Enron buying from and selling to itself. After six months, Enron would not be buying the barges back from Merrill but merely closing down the partnership and returning to Merrill its investment plus the guaranteed return.

The deal was submitted to Merrill's Debt Market Commitments Committee, where Robert Furst, a managing director of Merrill Lynch, and the Enron relationship manager at the time apparently supported it. The head of the Asset Lease and Finance Group, James A. Brown, was concerned, though, about Enron manipulating earnings. Others apparently thought that the amount was too small to be material given Enron's total revenues. Concern was also expressed about the firmness of Enron's commitment, and so Mr. Bayly talked directly with Andrew Fastow, who has testified that he said unequivocally that Merrill would not lose money on the deal and would receive a guaranteed return. Both Mr. Bayly and Mr. Brown insist that the Enron CFO promised only to make a "best effort" to find a buyer. According to other testimony, Mr. Bayly asked for Enron's commitment in writing but was told that Enron could not do that and get "the right accounting treatment." In the meantime, there was no due diligence in examining the three Nigerian barges and no bargaining over the price that Merrill would pay or the return, both of which would be expected in a real investment.

### Accepting the Deal

In the end, the deal was accepted. Merrill Lynch invested \$7 million; Enron recorded \$12 million in revenues; and six months later, Fastow's partnership LJM2 repurchased the barges for \$7.525 million, which represents Merrill's \$7 million investment plus a 15 percent annualized return. In 2003, the Securities and Exchange Commission (SEC) brought a suit alleging fraud. Messrs. Bayly, Brown, and Furst were convicted in 2004 along with another Merrill Lynch employee and one low-level Enron employee. Before these individuals were tried, Merrill Lynch settled with the SEC, paying \$80 million for the Nigerian barge deal and another transaction with Enron. In 2006, the convictions of the three former Merrill Lynch bankers were overturned on the grounds of a legal technicality over the interpretation of the federal fraud statute under which they were originally tried.

## SHARED WRITING: MERRILL LYNCH AND THE NIGERIAN BARGE DEAL

If Merrill-Lynch bankers believed that the deal would enable Enron to commit fraud, why might it be ethically wrong for them to enter into it? Suppose the bankers were unsure of Enron's intentions in proposing the deal. Explain whether they had any moral obligation to investigate the deal before accepting it.

Review and comment on at least two classmates' responses.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Martha Stewart: Inside Trader?

On December 27, 2001, Martha Stewart was en route with a friend from her home in Connecticut to a post-Christmas holiday in Mexico when her private plane landed for refueling in San Antonio, Texas.<sup>75</sup> While standing on the tarmac, she listened to a telephone message from her assistant, Ann Armstrong, reporting a call from Peter Bacanovic, her stockbroker at Merrill Lynch. The message relayed by her assistant was brief: "Peter Bacanovic thinks ImClone is going to start trading down." Stewart immediately returned the call, and at some point during the 11-minute conversation was put through to her broker's office at Merrill Lynch. Bacanovic was on vacation in Florida, and so she talked instead with his assistant, Douglas Faneuil. Faneuil later testified that, on orders from Bacanovic, he told Stewart that he had no information on the company but that the Waksal family was selling their shares in ImClone. Although Stewart denied being told this, she instructed Faneuil to sell all of her ImClone stock. Her 3,928 shares sold within the hour at an average price of \$58.43 a share, netting her approximately \$228,000. Stewart then made one more phone call, to Sam Waksal's office, leaving a message that Waksal's secretary scribbled as "Martha Stewart something is going on with ImClone and she wants to know what." During her vacation in Mexico, she reportedly told her friend, "Isn't it nice to have brokers who tell you those things?"

### The ImClone Trade

Martha Stewart became a national celebrity and self-made billionaire through her print and television presence and the many household products bearing her brand name. After a brief career on Wall Street as a stockbroker, she started a successful catering business that led to a succession of books on cooking and household decorating. The magazine *Martha Stewart Living* followed, along with a television series and a

partnership with Kmart. In 1999, her company, Martha Stewart Living Omnimedia (MSLO) went public, with Stewart as the CEO and chairman. MSLO was unique in that Martha Stewart herself was the company's chief marketable asset.

Sam Waksal was the founder, president, and CEO of ImClone Systems, Inc., a biopharmaceutical company that sought to develop biologic compounds for the treatment of cancers. Martha Stewart and Sam Waksal were close friends, having been introduced in the early 1990s by Stewart's daughter Alexis, who had dated Waksal for a number of years. It was also through Alexis that her mother and Waksal came to know Peter Bacanovic, who attended Columbia University in the mid-1980s while Alexis was enrolled at nearby Barnard College. Bacanovic worked briefly at ImClone before joining Merrill Lynch in 1993 as a broker, and Stewart and Waksal became two of his most important clients. Waksal helped Stewart achieve an advantageous split from her then-publisher Time Warner in 1997, and in gratitude, she invested an initial \$80,000 in ImClone stock. With a net worth of over \$1 billion, her investment in 2001 represented three-hundredths of 1 percent of her total holdings.

In 2001, the future of ImClone rested on the uncertain prospects of a single drug, Erbitux, for the treatment of advanced colon cancer. Erbitux was a genetically engineered version of a mouse antibody that showed great promise in early tests. In October, ImClone submitted a preliminary application to the Food and Drug Administration (FDA) for approval of Erbitux. This application was merely the first step that allowed the FDA to determine whether the research submitted by the company was sufficiently complete to begin a full FDA review. A decision on the application was expected by the end of December. On December 28, 2001, ImClone announced that the FDA had found the application to be incomplete and would not proceed to the next stage. After the news was announced, ImClone stock dropped 16 percent to \$46 a share.

The previous day, on the morning of December 27, Sam Waksal and his daughter asked Peter Bacanovic to sell all of their ImClone shares held at Merrill Lynch, which were worth over \$7.3 million. Merrill Lynch sold the ImClone stock of the daughter for approximately \$2.5 million but declined to sell Sam Waksal's shares, citing concern about insider trading. An attempt by Waksal to have his shares transferred to his daughter so that they could be sold by her failed. Separately, Sam Waksal's father sold shares worth more than \$8 million, and smaller amounts were sold by another daughter and a sister of Sam Waksal.

### The Aftermath

The Securities and Exchange Commission (SEC) quickly opened an investigation into suspected insider trading in ImClone stock. Faneuil later testified that Bacanovic initially told him that dumping Stewart's stock was part of a tax-loss

selling plan. After being informed by Faneuil that Stewart had made a profit, Bacanovic changed the story, explaining that Stewart had placed a stop-loss order to sell the stock if it dropped below \$60 a share. Stewart affirmed to federal investigators that she had given this instruction to Bacanovic and gave as a reason that she did not want to be bothered about the stock during her vacation. This conversation, she claimed, was with Bacanovic, though she had in fact talked only with Faneuil. She also said that she was unable to recall whether Sam Waksal had been discussed in the December 27 telephone conversation or whether she had been informed about stock sales by the Waksal family.

Before meeting with investigators, Stewart accessed the phone message log on her assistant's computer and changed the entry "Peter Bacanovic thinks ImClone is going to start trading downward" to "Peter Bacanovic re imclone," but afterward told her assistant to restore the original wording. Meanwhile, Bacanovic altered a worksheet that contained a list of Stewart's holdings at Merrill Lynch with notations in blue ballpoint ink to include "@\$60" by the entry for ImClone. An expert later testified in court that the ink for this entry was different from that used in the other notations.

In March 2003, Sam Waksal pleaded guilty to charges of securities fraud for insider trading, obstruction of justice, and perjury. He was later sentenced to seven years and three months in prison and ordered to pay \$4 million. The Department of Justice accepted a proposal from Martha Stewart's attorneys that she plead guilty to a single felony count of making a false statement to federal investigators that would probably avoid any prison time. However, Stewart decided that she could not do this and would take her chances in court. A justice department official said, "We had no desire to prosecute this woman" but indicated that the lying was too egregious to ignore.<sup>76</sup> Stewart and Bacanovic were charged with conspiracy, obstruction of justice, and perjury—but not insider trading. On March 5, 2004, a jury found both parties guilty. Stewart and Bacanovic were each sentenced to five months in prison, five months of home confinement, and two years of probation. Stewart was fined \$30,000 and Bacanovic, \$4,000. By selling her ImClone stock when she did, Stewart avoided a loss of approximately \$46,000. She estimated the total loss from her legal troubles to be \$400 million, including a drop in the value of MSLO stock and missed business opportunities.

In June 2003, the SEC brought a civil action for insider trading, which was separate from the criminal charges of which Stewart was found guilty. To convict Stewart of insider trading, the SEC would have to show that she had received material nonpublic information in violation of a fiduciary duty. The information that she received from Faneuil in the December 27 phone call was that the members of the Waksal family were selling their ImClone stock. Neither Faneuil nor Bacanovic had information about the FDA rejection of the Erbitux application that prompted the

sell-off. Neither one had a fiduciary duty to ImClone. However, Bacanovic owed a fiduciary duty to Merrill Lynch that he breached in ordering that information about the Waksal's sales be conveyed to Stewart.

Merrill Lynch had an insider trading policy that prohibited the disclosure of material nonpublic information to anyone who would use it to engage in stock trading. A confidentiality policy also prohibited employees from discussing information about a client with other employees except on a "strict need-to-know basis," and further stated, "We do not release client information, except upon a client's authorization or when permitted or required by law."

Since the information that the Waksals were selling was obtained by Bacanovic in his role as their broker, he breached his duty to Merrill Lynch. However, Martha Stewart denied that she was aware that Bacanovic was their broker. Moreover, as a former stockbroker who understood the law on insider trading, she knew that she could not act on information received from an insider like Waksal. But could she trade on information provided by Bacanovic, even if he was violating a fiduciary duty to Merrill Lynch? Stewart was apparently unconcerned about her first interview with federal investigators because, according to a close associate, "All she thought they wanted to talk about was whether Waksal himself had tipped her about the F.D.A. decision. She knew she was in the clear on that one."<sup>77</sup>

On August 7, 2007, the SEC announced a settlement with Martha Stewart and Peter Bacanovic.<sup>78</sup> Stewart agreed to pay a \$195,000 penalty and accept a five-year ban on serving as an officer or director of a public company. Bacanovic was ordered to pay \$75,000; he had previously received a permanent bar from work in the securities industry. The SEC's Director of Enforcement declared, "It is fundamentally unfair for someone to have an edge on the market just because she has a stockbroker who is willing to break the rules and give her an illegal tip. It's worse still when the individual engaged in the insider trading is the Chairman and CEO of a public company."<sup>79</sup>

#### SHARED WRITING: MARTHA STEWART: INSIDE TRADER?

Develop the argument that Martha Stewart was not really in possession of inside information that was disclosed in a breach of a fiduciary duty. How does her case differ from the insiders at Texas Gulf Sulphur or from other outsiders who have been convicted of insider trading? What specific features of the information that she obtained make her case different from those of convicted insider traders?

Review and comment on at least two classmates' responses.

▶ **A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.**

Post

0 characters | 140 minimum

## Case: Oracle's Hostile Bid for PeopleSoft

At a quickly convened board meeting on June 8, 2003, the directors of PeopleSoft considered their response to an unsolicited takeover offer from Oracle Corporation. Two days prior, Oracle's CEO, Lawrence J. (Larry) Ellison, announced that the company would seek to buy all of PeopleSoft's stock in a deal worth \$5.1 billion. Because the PeopleSoft executives who sat on the board had a vested interest in rejecting the offer, the board's independent directors, who had no stake in the outcome, formed a committee to address the issues. In deciding whether to accept the offer and how to repel it if need be, their fiduciary duty was to act solely in the interest of PeopleSoft's shareholders.

### Planning the Hostile Bid

Oracle and PeopleSoft were companies that developed and installed software for Enterprise Resource Planning (ERP), which enables business customers to integrate all data processing in a company across functions. Instead of separate computer software for accounting, finance, human resources, manufacturing, supply chain management, customer orders, and the like, ERP provides a unified system that operates from a common database. A few companies dominated the ERP business, with SAP, Siebel, and J. D. Edwards being the other major providers. Typically, an ERP system represents a very large investment by a company, and the installation may take a year or more. During the three to four years' period before a change to a next-generation system, support from the ERP provider is critical. Consequently, the choice of ERP systems is a matter of great importance to companies.

The 1990s was a period of growth in the ERP industry, but by 2003, the sales of systems were declining, and price competition was reducing profitability. Companies were able to expand primarily by branching out into new applications, which could be done most quickly by acquiring smaller companies. Accordingly, PeopleSoft entered into an agreement to purchase J. D. Edwards for \$1.8 billion. Not only did the two companies' products fit well together, but the merger of PeopleSoft and J. D. Edwards, which had 10 percent and 5 percent of the market, respectively, would enable the combined companies to exceed the 13 percent market share of Oracle. PeopleSoft announced the acquisition of J. D. Edwards on June 2, 2003.

Oracle had long considered PeopleSoft for an acquisition or merger. A year before the hostile bid, the two companies had engaged in talks that were eventually abandoned. However, Oracle anticipated a possible PeopleSoft acquisition of J. D. Edwards and had prepared a plan to be put into effect as soon as an acquisition was

announced. Ellison was quoted in the *Wall Street Journal* as saying, "We've got this war game in the box. This has all been pre-scripted. If they launched on J. D. Edwards, we were going to launch on them."<sup>80</sup> The Oracle bid was unusual, though, in that the offer of \$16 per share represented a mere 6 percent premium over the current price of PeopleSoft stock. Typically, a serious raider offers a premium of 20 percent or more. Furthermore, Oracle announced that it would not offer PeopleSoft applications to its customers but would seek to convert PeopleSoft's customers to Oracle's E-Business Suite. Although the merger would make Oracle the number two ERP, next only to SAP, Oracle seemed interested only in PeopleSoft's customers and not its software or employees.

The PeopleSoft CEO, Craig Conway, saw the takeover bid merely as a ploy for preventing the company's acquisition of J. D. Edwards and, at the same time, damaging PeopleSoft's business. The deal for acquiring J. D. Edwards, which involved the trade of stock, depended on the ability of PeopleSoft to maintain its stock price. However, the Oracle offer was likely to deter new customers from purchasing PeopleSoft applications because of the uncertainty over the future of the company. In a press release, Conway said, "By making an offer with the acknowledged intent of eliminating PeopleSoft's business, Oracle seeks to disrupt PeopleSoft's efforts to complete new sales, thus effectively damaging PeopleSoft's business even if Oracle never buys a single share of PeopleSoft Stock."<sup>81</sup> In private, Conway was more candid, deriding the bid as "classic Larry bad behavior" from "a company with a history of atrociously bad behavior."<sup>82</sup>

### Responding to the Bid

Conway was firmly against a consideration of Oracle's hostile bid. He told reporters that "there is no condition that I can even remotely imagine where PeopleSoft would be sold to Oracle."<sup>83</sup> However, the committee of independent board directors recognized that there were conditions under which it would be in the shareholders' interest to sell the company. The relevant questions for their decision were, what are those conditions, and have they been met?

**First, there was the matter of price.** Was \$16 per share a fair price for the company's stock, or should the board hold out for a higher offer? In takeovers, a better price might be offered not only by the original suitor but by a rival raider. This rival might be a "white knight," who makes a friendly offer to save the company from the clutches of an undesirable suitor. In takeovers, a bidder, like a house buyer, typically makes a low bid with the intent of raising the price eventually. On June 18, Oracle raised its offer to \$19.50 a share, a 22 percent increase in the bid price and a 29 percent premium over the price on the day Oracle announced its hostile bid.

**Second, what were Oracle's intentions in making an offer for PeopleSoft?** Larry Ellison strenuously denied that his intent was merely to harm PeopleSoft and derail the J. D. Edwards acquisition. To his critics Ellison replied, "I'm a rich guy, and I think \$5 billion is serious money." He added, "We absolutely think this is going to happen."<sup>84</sup> Moreover, many analysts thought that an acquisition would strengthen Oracle by giving the company new products, new employees, and new customers. According to one observer, "Ellison has a vision of ensuring that Oracle is, to a large extent, a vertically integrated company that is equipped to offer virtually any business software product or service to customers."<sup>85</sup> However, if the price that Oracle was willing to pay was high enough to induce PeopleSoft shareholders to sell, should Oracle's plans for the acquired company be of any concern to the board? If Oracle was not serious in acquiring and did not successfully absorb PeopleSoft, then it was Oracle's shareholders who would bear the loss, not the former PeopleSoft shareholders.

**Third, what would be the impact of selling PeopleSoft to Oracle on the company's existing customers?** Even if its customers eventually migrated to Oracle's E-Business Suite, Oracle might not provide adequate maintenance and upgrades for the PeopleSoft applications that customers were currently running. One solution to this problem that the board of directors considered was a Customer Assurance Plan (CAP) that would reimburse customers from two to five times the original cost of their software if an acquirer failed to provide adequate service during the life of a system. Such a guarantee would reassure not only customers who had already purchased PeopleSoft applications but also companies shopping for new software. CAP would also be a costly commitment that would increase the cost of a takeover for the acquirer. Although CAP would be a benefit to PeopleSoft's customers, the board had to consider whether it was in the best interest of the shareholders. Once in place, it probably could not be withdrawn by the board, and it might reduce the price that the shareholders could get for the company.

**Fourth, the board had to assess the effect of Oracle's bid on J. D. Edwards.** If the acquisition of J. D. Edwards were not completed quickly, the opportunity might be lost, and J. D. Edwards shareholders would not be able to realize the gain they expected from the deal. The J. D. Edwards CEO declared, "Oracle's unsolicited offer for PeopleSoft will only destroy value for our companies' shareholders, customers and employees and the technology community overall."<sup>86</sup> After the announcement of Oracle's bid, J. D. Edwards filed a suit against Oracle alleging that Oracle had wrongfully interfered in the sale of J. D. Edwards to PeopleSoft. Because the purchase agreement involved payment with PeopleSoft stock, the deal required the approval of the PeopleSoft shareholders, which could not be gained quickly. However, the board had the option of buying J. D. Edwards

for cash, which could be done without shareholder approval, and so the acquisition could be completed promptly. The question for the board, then, was whether to proceed with the J. D. Edwards acquisition, and if so, how to do it.

If the PeopleSoft board were to accept Oracle's offer, then it would need to rescind a "poison pill" that it had previously adopted as protection against a hostile takeover. The poison pill provided that in the event of an acquirer purchasing 20 percent of the stock, new shares would be issued to the shareholders at a low price. The effect of such a provision is to reduce the acquirer's percentage below 20 percent, and this provision would be triggered each time an acquirer increased its stake above that level. If the board decided to accept a bid for the company, the poison pill could be eliminated by board action. Although this protection effectively ensured that a takeover could not occur through the purchase of stock without board approval, a hostile raider could still take the difficult and more time consuming route of a proxy battle to elect its own members to the board, who would then rescind the poison pill.

### The Outcome

At the board meeting on June 8, the directors concluded that they needed more information before making a decision, and so they adjourned and scheduled a meeting for June 11, at which time the board would address all of the issues facing them in responding to Oracle's hostile bid. On June 11, the PeopleSoft directors rejected Oracle's \$16-per-share offer as too low and adopted a Customer Assurance Plan. In August 2003, PeopleSoft completed the acquisition of J. D. Edwards. Oracle and PeopleSoft engaged in extensive court battles over many issues, including the poison pill and CAP. During 18 months of skirmishing, Oracle raised its bid price five times, eventually offering \$26.50 per share.<sup>87</sup> On December 13, 2004, the PeopleSoft board announced that it would accept this offer. In the end, PeopleSoft was acquired by Oracle for \$10.3 billion.

#### SHARED WRITING: ORACLE'S HOSTILE BID FOR PEOPLESOFT

Given that PeopleSoft was eventually acquired by Oracle at a price that PeopleSoft shareholders accepted, it might be argued that this case illustrates how the market for corporate control ought to work. What problems might nonetheless be found in the workings of the market for corporate control in this case?

Review and comment on at least two classmates' responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum



## Chapter 12

# Corporate Social Responsibility



## Learning Objectives

- 12.1** Recognize the significance and implications of corporate social responsibility for businesses, how CSR is commonly demonstrated, and its related concepts
- 12.2** Describe the main arguments for and against CSR as both morally permissible and morally required for companies
- 12.3** Analyze the arguments that a market for virtue makes CSR a profitable strategy and a source of competitive advantage
- 12.4** Summarize the important aspects of successful CSR programs, the difficulties with measuring the social performance of companies, and various attempts at measurement
- 12.5** Compare how nonprofit and for-profit social enterprises operate and can compete successfully in the marketplace

## Case: Competing Visions at Malden Mills

The tragic fire that struck Malden Mills in 1995 and made its owner, Aaron Feuerstein, an American folk hero was the beginning of a struggle that eventually pitted Mr. Feuerstein against the might of GE Capital over competing visions of how to run the company.

### Response to the Fire

After three of the Malden Mills' eight buildings in Lawrence, Massachusetts, burned to the ground on the night of December 11, Aaron Feuerstein, the patriarch of this family-owned firm, announced that wages and benefits for the 3,100 affected workers would be continued and that the facilities would be rebuilt on the same site. This heartfelt concern for the company's workers and the community won Mr. Feuerstein widespread acclaim as an exemplar of corporate social responsibility. Many business people wondered why he would not use the \$300 million in insurance to move overseas to a low-wage country as his competitors were doing—or simply take the money and retire. Instead, the rebuilding of the plants required an additional \$100 million investment. For his compassionate response, Mr. Feuerstein received numerous awards, invitations to speak, and honorary degrees at a time

when Americans were disturbed by massive layoffs ordered by highly paid CEOs. President Bill Clinton invited him to a conference on corporate social responsibility and mentioned him in his 1996 State of the Union address.

However, heavy debt from the rebuilding forced Malden Mills into bankruptcy in November 2001, and when the company emerged from bankruptcy in October 2003, it was owned and operated by its former creditors, led by investment giant GE Capital. Aaron Feuerstein held the largely ceremonial posts of president and nonexecutive chairman and retained a 5 percent stake, but majority ownership and operational control of the company was in the hands of the investors who had come to the company's aid. Now, Mr. Feuerstein wanted to repurchase the company that his grandfather founded in 1906 in order to keep the much-needed jobs in Lawrence. The plan of the current owners, though, was to keep control and cut costs by sending operations to Asia. The company's CFO wrote, in August 2003, that management would probably move "a substantial part of Malden's operations overseas in the next few years."<sup>1</sup>

### Meaning of Social Responsibility

Aaron Feuerstein's response to the fire—which also included generous support for the injured workers and their families—was motivated by his religion (he is an observant Jew), by a sense of responsibility as the head of a family-owned business, and by a

certain pride in his ability to overcome obstacles. As he watched the blaze, he was heard to say, “This is not the end.”<sup>2</sup> According to a *Boston Globe* reporter, he told himself with “incredible confidence,” “I know I can find a way.”<sup>3</sup> He later explained his decision as a matter of responsibility. “I have a responsibility to the worker. . . . I have an equal responsibility to the community. It would have been unconscionable to put 3,000 people on the streets and deliver a death blow to [the city of Lawrence].”<sup>4</sup> He described his view of corporate social responsibility as follows:

Corporate responsibility to me means yes, you must . . . take care of the shareholder, but that is not your exclusive responsibility. The CEO has responsibility to his workers, both white collar and blue collar, as well, and he has responsibility to his community and city. And he has to be wise enough to balance out these various responsibilities and . . . to act justly for the shareholder, as well as the worker.<sup>5</sup>

Although Mr. Feuerstein’s decision to rebuild and even expand in Lawrence has been criticized from a business point of view, some observers see in his decision an astute business logic—that he is “crazy like a fox.”<sup>6</sup>

#### **How did Mr. Feuerstein apply this type of logic in the past?**

In the highly competitive fabric industry, where most production now takes place in low-wage countries, Malden Mills had managed to survive and even prosper in the United States by focusing on product quality. After a bankruptcy in 1982 caused by the collapse of the market for the faux-fur fabric on which Malden Mills depended, the company developed Polartec and Polarfleece, two widely used materials for outer garments that it sold to companies like L.L. Bean, Lands’ End, Patagonia, North Face, and Eddie Bauer. Using equipment that requires skilled workers, the company turned out consistently high-quality fabric that was highly valued by these apparel manufacturers—and by *their* customers.

Aaron Feuerstein also worked closely with customers to achieve a high degree of loyalty. He saw that if the company were to rebuild quickly, he would have to keep his highly skilled workers ready to return to production. He recognized, however, that layoffs are sometimes necessary, especially

when technological advances improve worker productivity. He said that at Malden Mills, they had always tried to combine cutbacks in one area with an expansion in another so as to keep workers. Furthermore, he explained:

[W]e concentrate less on . . . the cuttable expense of the labor and more on research and development to make better quality products . . . and to differentiate ourselves from our competitors in the market place. We pay more than the average mill does, and so that’s fine, because we don’t concentrate on pay, we concentrate on where the real profit is in making the product better.<sup>7</sup>

#### **Whose vision should shape Malden Mills’ future policies?**

Although Aaron Feuerstein deserved credit for leading Malden Mills through turbulent times, the relevant question was who should lead going forward. The subsequent CEO, who was a career textile executive installed by GE Capital and the other major investors, did not have the same vision.<sup>8</sup> But what vision did Malden Mills need at that point in time? There is a certain irony that chief among the investors who came to the company’s rescue was GE Capital, because GE’s former CEO Jack Welch was considered to be a ruthless, profit-minded executive, the opposite of Aaron Feuerstein. The case for Jack Welch’s vision was expressed in the following dissenting observation:

Feuerstein’s pledge to continue paying his workers eventually cost them their jobs, and cost Feuerstein his company. Feuerstein ran out of money, and Malden Mills was forced to declare bankruptcy. Welch, on the other hand, turned GE from a sleepy home-appliance company into an international mega-corporation that today is a leader in several industries. For every job slashed, he eventually created dozens of new ones. For all the praise heaped on Feuerstein and scorn heaped on Welch, it is Welch, not Feuerstein, whose . . . management style did the most good for the most people.<sup>9</sup>

The choice between these two competing visions would be made largely by a calculation of the market worth of Malden Mills under the leadership of Aaron Feuerstein versus its value under GE Capital.

## Points to Consider . . .

Although corporations are business organizations run primarily for the benefit of shareholders, they have a wide-ranging set of responsibilities—to their own employees, to customers and suppliers, to the communities in which they are located, and to society at large. Most corporations recognize these responsibilities and make a serious effort to

fulfill them. Often, these responsibilities are set out in formal statements of a company’s principles or beliefs. Many companies have institutionalized corporate social responsibility (CSR) as an integral part of their operations. In addition, there are many outside groups, including non-governmental organizations (NGOs), socially responsible investors, and consultancy firms, that monitor companies’ CSR activities and provide their services. This public

demand for social responsibility has led to a number of rankings of CSR by outside groups and to formal reporting by corporations of their CSR performance. Today, CSR is a worldwide movement that is gaining increasing acceptance and visibility.

At issue in the discussion of CSR are three questions:

1. Why do corporations have a social responsibility? That is, what is the basis for such a responsibility?
2. What is the extent of this responsibility, or what exactly do corporations have a responsibility to do?
3. Perhaps most important, how should corporations decide what CSR activities to undertake, and what is required to implement CSR programs effectively?

As CSR has gained increasing acceptance, attention has moved away from the first two questions to the third. The focus of business today is no longer on *whether* to engage in corporate social responsibility but *how* to do it.<sup>10</sup> As companies have come to accept a social responsibility, they have also recognized the benefits of CSR activities for themselves as well as society. The most progressive companies effectively use CSR to protect their reputations and to develop and implement corporate strategy. These companies are viewing CSR less as philanthropy and more as savvy corporate–community involvement or as profitable corporate social initiatives.<sup>11</sup>

In addition to the social responsibility programs of conventional business corporations, a new kind of business organization has arisen with an explicit mission to address pressing social needs. Known as *social enterprises*, these organizations, which may be incorporated in the nonprofit or for-profit form, seek to operate as businesses that are socially responsible not merely in their operations or as an additional activity but at their very core. Social enterprise—which is also called social venturing, social innovation, and social entrepreneurship—aims to deliver critical social services that have been provided traditionally by nonprofit organizations and government welfare agencies. The motivating force behind social enterprise is the belief that business has greater power to solve social problems than has been commonly recognized.

This chapter examines the concept of corporate social responsibility and social enterprise. It begins with the debate over the question of whether corporations have a social responsibility and why, and then moves into the reasons why corporations have come increasingly to accept CSR and how they are implementing it effectively. The concept of CSR is closely linked to two other prominent movements: corporate social performance and corporate citizenship. The meaning and implication of these concepts are also considered in this chapter. The chapter concludes with a section on the new development of social enterprise.

## WRITING PROMPT

### A “Good” Time for CSR?

Consider the three essential questions about corporate social responsibility. Why do you think most companies today are focusing on the third question of how best to implement CSR? Can a socially responsible approach to business, like Feuerstein’s leadership at Malden Mills, also be financially responsible? Or is CSR something that can or should be dropped during difficult times?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 12.1: The CSR Debate

### 12.1 Recognize the significance and implications of corporate social responsibility for businesses, how CSR is commonly demonstrated, and its related concepts

Although some elements of CSR can be traced back to the mid-nineteenth century, the concept of corporate social responsibility originated in the 1950s when American corporations rapidly increased in size and power, thus creating a concern for their legitimacy in a democracy.<sup>12</sup> The concept continued to figure prominently in public debate during the 1960s and 1970s as the nation confronted pressing social problems, such as poverty, unemployment, race relations, urban blight, and pollution. Corporate social responsibility became a rallying cry for diverse groups demanding change in American business during a time of great social unrest.

CSR did not receive much attention in Europe until the 1980s, but the concern for the subject and organized activity surrounding it are more prominent there today than in the United States.<sup>13</sup> Among the factors at work in Europe are the integration of countries into the European Union, the deregulation of the economy, and the decline of the welfare state. Many governments in Europe have promoted CSR as a way of replacing the traditional role of the state in regulating business and providing for people’s well-being.

In the last two decades of the twentieth century, American corporations generally recognized a responsibility to society, but that responsibility was weighed against the changes brought about by technology and the demands of being competitive in a rapidly changing global economy. Strong market pressures to be profitable constrained the ability of companies to expend significant resources for CSR. At the same time, however, the increasing globalization of business made corporations more vulnerable to criticism for their operations abroad. Especially corporations with valuable brand names, such as Nike, needed to protect their reputations in the face of adverse publicity and organized protests. In the early years of the new century, CSR is firmly

established. As *The Economist* magazine observed, “CSR is thriving. It is now an industry in itself, with full-time staffs, websites, newsletters, professional associations and massed armies of consultants. This is to say nothing of the NGOs [nongovernmental organizations] that started it all.”<sup>14</sup>

Some contend that corporate social responsibility is altogether a pernicious idea. The well-known conservative economist Milton Friedman wrote, in *Capitalism and Freedom*, “Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than making as much money for their stockholders as possible.”<sup>15</sup> He continued,

The view has been gaining widespread acceptance that corporate officials . . . have a “social responsibility” that goes beyond serving the interest of their stockholders. . . . This view shows a fundamental misconception of the character and nature of a free economy. In such an economy, there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud. . . . It is the responsibility of the rest of us to establish a framework of law such that an individual pursuing his own interest is, to quote Adam Smith . . . , “led by an invisible hand to promote an end which was no part of his intention.”<sup>16</sup>

At the other extreme are critics who would like corporations to be more socially responsible but are mistrustful. They consider talk about corporate social responsibility to be a public relations ploy designed to legitimize the role of corporations in present-day American society, to divert attention away from the destructive social consequences of corporate activity, and to forestall more appropriate government action.<sup>17</sup>

Even those who are more favorably disposed to the idea have reservations about the ability of corporations to respond effectively to social issues. Businesses are single-purpose institutions, conceived, organized, and managed solely in order to engage in economic activity. As such, they lack the resources and the expertise for solving major social problems, and some add that they lack the legitimacy as well. Corporate executives are not elected officials with a mandate from the American people to apply the resources under their control to just any ends that they deem worthwhile.

Furthermore, the idea that corporations should be more socially responsible fails to give adequate ethical guidance to the executives who must decide which causes to pursue, how much to commit to them, and how to evaluate their effectiveness. Much CSR activity is undertaken in response to outside pressures, and so the leaders of a company need to decide which pressures to respond to and how to address them effectively. These problems are especially acute in view of the fact that all choices involve trade-offs. A program to increase minority employment, for example, might end up

reducing wages for employees or raising prices for consumers. Or such a program might be adopted at the expense of achieving improvements in worker health and safety or reductions in the amount of pollution. Corporations committed to exercising greater social responsibility need more specific moral rules or principles to give them reasons for acting in one way rather than another.

### 12.1.1: Meaning of CSR

All accounts of corporate social responsibility recognize that business firms have not one but many different kinds of responsibilities, including economic and legal responsibilities. Corporations have an *economic* responsibility to produce goods and services and to provide jobs and good wages to the workforce while earning a profit. Economic responsibility also includes the obligation to seek out supplies of raw materials, to discover new resources and technological improvements, and to develop new products. In addition, business firms have certain *legal* responsibilities. One of these is to act as a fiduciary, managing the assets of a corporation in the interests of shareholders, but corporations also have numerous legal responsibilities to employees, customers, suppliers, and other parties. The vast body of business law is constantly increasing as legislatures, regulatory agencies, and the courts respond to greater societal expectations and impose new legal obligations on business.

The concept of corporate social responsibility is often expressed as the voluntary assumption of responsibilities that go beyond the purely economic and legal responsibilities of business firms.<sup>18</sup> More specifically, social responsibility, according to some accounts, is the selection of corporate goals and the evaluation of outcomes not solely by the criteria of profitability and organizational well-being but by ethical standards or judgments of social desirability. The exercise of social responsibility, in this view, must be consistent with the corporate objective of earning a satisfactory level of profit, but it implies a willingness to forgo a certain measure of profit in order to achieve noneconomic ends.

Archie B. Carroll views social responsibility as a four-stage continuum.<sup>19</sup> Beyond economic and legal responsibilities lie ethical responsibilities, which are “additional behaviors and activities that are not necessarily codified into law but nevertheless are expected of business by society’s members.”<sup>20</sup> At the far end of the continuum are discretionary responsibilities that involve philanthropy and other voluntary contributions to community organizations, often involving the arts, education, and public welfare. These responsibilities are not legally required or even demanded by ethics, but corporations accept them in order to meet society’s expectations.

S. Prakash Sethi notes that social responsibility is a relative concept: What is only a vague ideal at one point in time or in one culture may be a definite legal requirement

at another point in time or in another culture. In most of the advanced nations of the world, fulfilling traditional economic and legal responsibilities is no longer regarded as sufficient for legitimizing the activity of large corporations. Corporate social responsibility can thus be defined as “bringing corporate behavior up to a level where it is congruent with the prevailing social norms, values, and expectations of performance.”<sup>21</sup>

In 1971, the Committee for Economic Development (CED) issued an influential report that characterized corporate social responsibility in a similar fashion but without an explicit mention of legal responsibilities. The responsibilities of corporations are described in this report as consisting of three concentric circles. Explore Figure 12.1 below to learn about the three levels of responsibility identified by the CED.

**Figure 12.1** The Expanding Dimensions of CSR

**1. Economic Responsibilities**

Basic responsibilities to create employment, produce goods and services and improve the efficient operation of business to earn a profit.

**2. Legal Responsibilities**

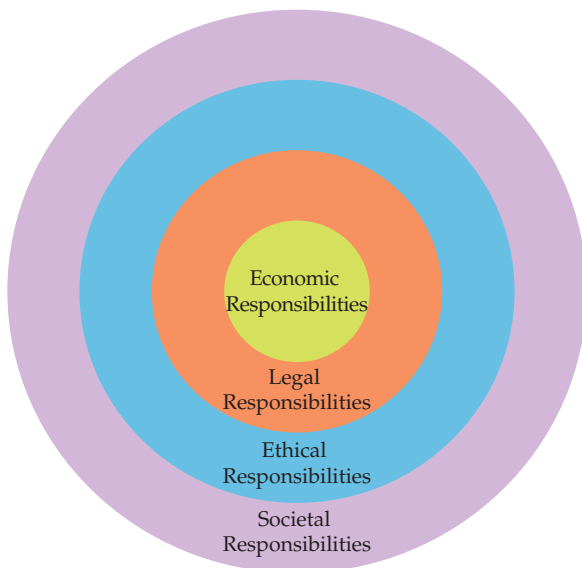
Meeting the fiduciary duty to manage corporate assets in the interests of shareholders and compliance with existing laws and regulations protecting employees, customers, communities and other parties.

**3. Ethical Responsibilities**

An awareness of the changing ethical priorities that are not expressed in the law: for example, environmental conservation; fairer relationships with employees; and improved treatment of customers.

**4. Societal Responsibilities**

Actively addressing societal challenges through philanthropy and collaboration with other organizations. Society is beginning to turn to corporations for help with major social problems such as poverty, education and urban blight.



The outer circle of responsibilities—the responsibility to proactively address larger problems in society—arises not so much because the public considers business singularly responsible for creating these problems, but because it feels large corporations possess considerable resources and skills that could make a critical difference in solving these problems.<sup>22</sup>

## WRITING PROMPT

### Voluntary CSR

Why do you think the expectation that businesses act in a socially responsible manner has not been matched with a legal requirement to do so? In your opinion, does this diminish the importance of CSR? How might CSR be made a legal requirement for businesses?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 12.1.2: Examples of CSR

Although there are some disagreements about the meaning of corporate social responsibility, there is general agreement on the types of corporate activities that show social responsibility. Among these are the following:

**1. Choosing to operate on an ethical level that is higher than what the law requires.**

Examples

- Motorola’s code of ethics prohibits payments of any kind to government officials, even when the payments are permitted by U.S. and local laws.
- Mattel closely monitors its factories in China to ensure that its high labor standards are observed.

**2. Making contributions to civic and charitable organizations and nonprofit institutions.**

Examples

- American companies contribute, on average, 1 percent of pre-tax net revenues to worthy causes.
- Many large corporations operate nonprofit foundations that fund grant applications from worthy philanthropic organizations.

**3. Providing benefits for employees and improving the quality of life in the workplace beyond economic and legal requirements.**

Examples

- Family-friendly programs such as flexible work and childcare
- Paid leave for volunteer work (see the Timberland case study).

**4. Taking advantage of an economic opportunity that is judged to be less profitable but more socially desirable than some alternatives.**

Examples

- Starbucks pays an above-market rate for fair-trade coffee that benefits growers in poor countries (see the Starbucks case study).
- Home Depot ensures that none of the wood it sells comes from old-growth or endangered forests.

**5. Using corporate resources to operate a program that addresses some major social problem.**

## 6. Examples

- AT&T devotes substantial resources to promoting diversity among its employees, suppliers, and local communities.
- Major pharmaceutical firms donate drugs for public health programs in less-developed countries. For example, Merck developed and now gives away in Africa a drug for the treatment of the disease river blindness.

Although these activities are all beyond the economic and legal responsibilities of corporations and may involve some sacrifice of profit, they are not necessarily antithetical to corporate interests. For example, corporate philanthropy that makes the community in which a company is located a better place to live and work results in direct benefits. The “goodwill” that socially responsible activities create makes it easier for corporations to conduct their business. High standards and socially responsible products also serve to protect and even enhance a company’s reputation and to attract and retain loyal employees and customers.

It should come as no surprise, then, that some of the most successful corporations are also among the most socially responsible. In 2015, a list of the 10 companies with the best CSR reputation, as reported by the global advisory firm Reputation Institute, was headed by BMW and Google and included Disney, Apple, and Intel.<sup>23</sup> These companies are led by executives who see that even the narrow economic and legal responsibilities of corporations cannot be fulfilled without the articulation of noneconomic values to guide corporate decision making and the adoption of non-traditional business activities that satisfy the demands of diverse constituencies.

### 12.1.3: Related Concepts

An important aspect of corporate social responsibility is the responsiveness of corporations—that is, the ability of corporations to respond in a socially responsible manner to new challenges.<sup>24</sup> William C. Frederick explains that the concept of *corporate social responsiveness* “refers to the capacity of a corporation to respond to social pressures.”<sup>25</sup> The emphasis of corporate social responsiveness, in other words, is on the *process* of responding or the readiness to respond, rather than on the *content* of an actual response. Thus, a socially responsive corporation uses its resources to anticipate social issues and develop policies, programs, and other means of dealing with them. The management of social issues in a socially responsive corporation is integrated into the strategic planning process, instead of being handled as an ad hoc reaction to specific crises.

The *content* of a response is also important because it represents the outcome of being socially responsible.

Donna Wood has combined all three elements in the concept of *corporate social performance*<sup>26</sup>:

1. the *principle* of being socially responsible,
2. the *process* of social responsiveness, and
3. the socially responsible *outcome*.

Use Table 12.1 to apply the elements of corporate social performance to the environmental concerns that a corporation may have regarding the packaging of its products.

**Table 12.1** Socially Responsible Packaging

What would be the principles, processes, and outcomes for socially responsible packaging?

CSR Element	Element Description
Principle	The _____ would lead the company to recognize an obligation to change its packaging in order to protect the environment.
Process	The _____ might consist of establishing an office of environmental affairs or working with environmentalists to develop new packaging.
Outcome	The _____ could include the switch to environmentally responsible packaging and perhaps building facilities to recycle the packaging.

The term “corporate citizenship,” which gained currency in the 1990s, especially in Europe, is often used interchangeably with “corporate social responsibility” and “corporate social performance,” but it sometimes has a broader meaning to include the beneficial impacts of a business organization on all groups in society, on society as a whole, and on the environment. According to one definition, “corporate citizenship is the process of identifying, analyzing and responding to the company’s social, political and economic responsibilities as defined through law and public policy, stakeholder expectations, and voluntary acts flowing from corporate values and business strategies.”<sup>27</sup>

In contrast to CSR, which is often conceived to be voluntary activities of a company that are in addition to its core business, corporate citizenship focuses on the integration of social and environmental concerns into a company’s policies and practices, so that all business is done as a “good citizen.” The language of citizenship implies a set of obligations that arises in virtue of membership in a larger community to which something is “owed” in return for enjoying certain privileges. The popular idea that society gives corporations a “license” to operate fits well with the idea of citizenship. The language of citizenship generally has greater appeal to businesses and NGOs than the terminology of CSR, which may also account for its widespread adoption in recent years. However, corporations are not citizens in the sense of having all the rights and obligations of the citizens of a state, and so the term “corporate citizenship” may be misleading and unhelpful in understanding the responsibilities of corporations.<sup>28</sup>

## WRITING PROMPT

### Responsibilities of “Corporate Citizens”

The responsibilities of U.S. citizens include paying taxes, serving on a jury, and voting. Are there similar responsibilities for corporations? How might identifying such responsibilities help a corporation become a better citizen?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 12.2: Normative Case for CSR

### 12.2 Describe the main arguments for and against CSR as both morally permissible and morally required for companies

The initial debate over CSR in the 1950s and 1960s was largely about the rationale for and the extent of corporations’ social responsibility. Was CSR something that corporations were morally obligated or, at least, morally permitted to do? What was the moral basis for such responsibility, and what specifically were corporations responsible for doing? Opponents of the idea of CSR, such as Milton Friedman, argued on moral grounds that corporations ought not to engage in CSR at all unless doing so benefited shareholders, while proponents offered arguments for the position that corporations were morally permitted to engage in some voluntary socially responsible activity and, in some situations, could be morally faulted for not doing so. The starting point for most of the arguments for and against corporate social responsibility is what has been called “classical view” of the corporation, which is the dominant conception, at least in the United States.

### 12.2.1: Classical View

The classical view, which prevailed in the nineteenth and twentieth centuries, is still very influential today, not only within the business community but also among academics. The origins of the classical view lie in society’s reactions to the social ills and labor unrest in late nineteenth-century capitalism, and in attempts of early twentieth-century business leaders to build public support for the rapidly growing industrial system. In the 1920s, the concern of the American business community was mainly to counter the demands of organized labor and the progressive reform movement, while the focus in the 1950s was to gain acceptance for the large corporations that had emerged from industrial mobilization during World War II. The classical view of corporate social responsibility was developed not by outsiders in order to pressure business but by business leaders themselves as a response to outside pressure.<sup>29</sup>

**EXPRESSION OF THE CLASSICAL VIEW** The classical view is expressed by James W. McKie in three basic propositions.

1. Economic behavior is separate and distinct from other types of behavior, and business organizations are distinct from other organizations, even though the same individuals may be involved in business and nonbusiness affairs. Business organizations do not serve the same goals as other organizations in a pluralistic society.
2. The primary criteria of business performance are economic efficiency and growth in production of goods and services, including improvements in technology and innovations in goods and services.
3. The primary goal and motivating force for business organizations is profit. The firm attempts to make as large a profit as it can, thereby maintaining its efficiency and taking advantage of available opportunities to innovate and contribute to growth.<sup>30</sup>

In the classical view, corporations should engage in purely economic activity and be judged in purely economic terms. Social concerns are not unimportant, but they should be left to other institutions in society.

In addition, holders of the classical view generally admit the legitimacy of three other functions of government that place limits on business activity.<sup>31</sup>

1. First, business activity generates many *externalities*, that is, social harms, such as worker injury and pollution, which result indirectly from the operation of business firms. In order to prevent these harms or to correct them after they occur, it is proper for government to act—by requiring safer working conditions and pollution controls, for example.<sup>32</sup>
2. Second, the operation of a free-market economy results in considerable *inequalities* in the distribution of income and wealth. Insofar as it is desirable as a matter of public policy to reduce these inequalities, it is appropriate for government to undertake the task by such means as progressive taxation and redistribution schemes. It is the job of government, in other words, and not business, to manage the equity/efficiency trade-off.<sup>33</sup>
3. Third, free markets are prone to *instability* that manifests itself in inflation, recessions, unemployment, and other economic ills. Individual firms are too small to have much effect on the economy as a whole, and so government must step in and use its powers of taxation, public expenditure, control of the money supply, and the like to make the economy more stable.

The classical view is part of a larger debate about the legitimate role of the corporation in a democracy. In his introduction to the influential volume *The Corporation in*

*Modern Society*, Edward Mason described the problem of the modern corporation as follows: America is a “society of large corporations . . . [whose] management, is in the hands of a few thousand men. Who selected these men, if not to rule over us, at least to exercise vast authority, and to whom are they responsible?”<sup>34</sup> The classical view responds to this problem by insisting that corporate power must be harnessed to a larger social good if it is not to become tyrannical. Confining corporations to economic ends is intended, in part, to limit their role in society so as to preserve other kinds of institutions, both public and private.

**JUSTIFYING THE CLASSICAL VIEW** Business activity, in the classical view, is justified partly on the ground that it secures the well-being of society as a whole. The crux of this argument is the efficacy of Adam Smith’s invisible hand in harmonizing self-interested behavior to secure an end that is not a part of anyone’s intention. This justification also depends on the ability of the rest of society to create the conditions necessary for the invisible hand to operate and to address social problems without the aid of business. The debate over the workings of the invisible hand cannot be settled here, but the invisible hand argument, upon which the classical view depends, is not incompatible with certain arguments for corporate social responsibility.

**First, a certain level of ethical conduct is necessary for the invisible hand to operate, or indeed for business activity to take place at all.** Milton Friedman speaks of the “rules of the game,” by which he means “open and free competition, without deception or fraud.” Theodore Levitt, in his article “The Dangers of Social Responsibility,” says that aside from seeking material gain, business has only one responsibility, and that is “to obey the elementary canons of everyday face-to-face civility (honesty, good faith, and so on).”<sup>35</sup> The “rules of the game” and “face-to-face civility” impose not inconsequential constraints on business. Presumably, the prohibition against deception and fraud obligates corporations to deal fairly with employees, customers, and the public and to avoid sharp sales practices, misleading advertising, and the like.

The moral minimum of the market also includes an obligation to engage in business without inflicting injury on others. Critics of Levitt’s position observe,

Levitt presents the reader with a choice between, on the one hand, getting involved in the management of society . . . and, on the other hand, fulfilling the profitmaking function. But such a choice excludes another meaning of corporate responsibility: the making of profits in such a way as to minimize social injury. Levitt at no point considers the possibility that business activity may at times injure others and that it may be necessary to regulate the social consequences of one’s business activities accordingly.<sup>36</sup>

Thus, corporations in a free market may have an obligation not to pollute the environment and to clean up any pollution they cause.

It may also be in the best interests of a corporation to operate above the moral minimum of the market. Corporations that adhere only to the moral minimum leave themselves open to pressure from society and regulation by government. One of the major reasons advanced for corporations to exercise greater social responsibility is to avoid such external interference. By “internalizing” the expectations of society, corporations retain control over decision making and avoid the costs associated with societal pressure and government regulation.

**Second, corporations have become so large and powerful that they are not effectively restrained by market forces and government regulation, as the invisible hand argument assumes.** Some self-imposed restraint in the form of a voluntary assumption of greater social responsibility is necessary, therefore, for corporate activity to secure the public welfare. Keith Davis expressed this point succinctly in the proposition “*social responsibility arises from social power.*”<sup>37</sup> He also cited what he calls the Iron Law of Responsibility: “In the long run, those who do not use power in a manner which society considers responsible will tend to lose it.”<sup>38</sup> The need for greater social responsibility by corporations, then, is an inevitable result of their increasing size and influence in American society.

Holders of the classical theory argue in reply that precisely because of the immense power of corporations, it would be dangerous to unleash it from the discipline of the market in order to achieve vaguely defined social goals.<sup>39</sup> Kenneth E. Goodpaster and John B. Matthews, Jr., concede that this is a matter for serious concern, but they argue in response:

What seems not to be appreciated is the fact that power affects when it is used as well as when it is not used. A decision by [a corporation] . . . not to exercise its economic influence according to “non-economic” criteria is inevitably a moral decision and just as inevitably affects the community. The issue in the end is not whether corporations (and other organizations) should be “unleashed” to exert moral force in our society but rather how critically and self-consciously they should choose to do so.<sup>40</sup>

**Third, the classical view assumes that business is best suited to provide for the economic well-being of the members of a society, whereas noneconomic goals are best left to government and the other noneconomic institutions of society.** This sharp division of responsibility is true at best only as a generalization, and it does not follow that corporations have *no* responsibility to provide a helping hand. Corporations cannot attempt to solve every social problem, of course, and so some criteria are needed for distinguishing those situations in which corporations have an obligation to



assist other institutions. John G. Simon, Charles W. Powers, and Jon P. Gunnemann propose the following four criteria:

1. The urgency of the need;
2. The proximity of a corporation to the need;
3. The capability of a corporation to respond effectively;
4. The likelihood that the need will not be met unless a corporation acts.<sup>41</sup>

Accordingly, a corporation has an obligation to address social problems that involve more substantial threats to the well-being of large numbers of people, that are close at hand and related in some way to the corporation's activity, that the corporation has the resources and expertise to solve, and that would likely persist without some action by the corporation.

### WRITING PROMPT

#### Reconciling the Classical View of Corporations and CSR

In your own words, summarize the main points of the classical view of business and explain the counterarguments that support CSR.

The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 12.2.2: Friedman on CSR

The best-known critic of corporate social responsibility is perhaps Milton Friedman. Friedman's main argument against CSR is that corporate executives, when they are acting in their official capacity and not as private persons, are agents of the shareholders of the corporation. As such, executives of a corporation have an obligation, indeed a fiduciary duty, to make decisions in the interests of the shareholders, who are ultimately their employers.

**FIDUCIARY ARGUMENT** Friedman's formulation of this fiduciary argument begins with a question about the meaning of social responsibility. He asked,

*What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example,*

- that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation.
- Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment.
- Or that, at the expense of corporate profits, he is to hire "hardcore" unemployed instead of better-qualified

available workmen to contribute to the social objective of reducing poverty.

In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.<sup>42</sup>

The fiduciary argument does not sanction an unrestrained pursuit of profit. Friedman himself acknowledges that business must observe certain essential limitations on permissible conduct, which he describes as the "rules of the game." Presumably, he would also grant the necessity of government with limited powers for setting and enforcing rules. Business activity requires, in other words, a minimal state in order to prevent fraud and anticompetitive practices and to enforce contracts and the basics of commercial law. Friedman recognizes, further, that many supposed socially responsible actions are really disguised forms of self-interest. Contributions to schools, hospitals, community organizations, cultural groups, and the like are compatible with the classical view insofar as corporations receive indirect benefits from the contributions. All Friedman asks is that corporations recognize these as effective means for making a profit and not as philanthropic activities.

The fiduciary argument is compatible, then, with some intervention in business activity by government in order to secure the public welfare. The important point to recognize is that the restraints are almost entirely *external*. The primary burden for ensuring that corporations act in a way that is generally beneficial rests on society as a whole, which is charged by Friedman with the task of creating a framework of law that allows business firms to operate solely in their self-interest. The fiduciary argument, therefore, does not permit corporations to *act* in a socially irresponsible manner; it only relieves them of the need to *think* about matters of social responsibility. In a well-ordered society, corporations attend to business while government and other institutions fulfill their proper roles.

It is questionable, however, whether such a neat division of responsibility between business and government can be realized in practice.

First, if it is the role of government to set the "rules of the game," it is difficult to see how, on Friedman's account, any lobbying or other interference in government decision making can be justified.

How can one claim that business has no responsibility except to play within the rules of the game set by government and then allow business to also set the rules?

Once business assumes part of the role of government in setting rules, then it assumes some of the responsibilities of government to provide for society's welfare.

Second, it may not be possible for government to address the problems of externalities, inequality, and stability without the cooperation of business. If so, then it is reasonable to expect corporations to take some responsibility for reducing pollution, for example, and not rely solely on government regulation.

**TAXATION ARGUMENT** In addition to the fiduciary argument, Friedman offers what might be called the taxation argument. Investors, according to the taxation argument, entrust their money to the managers of corporations in order to make profits for the shareholders. When corporate executives spend money to pursue social ends in the way Friedman describes—such as by hiring “hardcore” unemployed people over others who may be better qualified—they take on a role of imposing taxes and spending the proceeds that properly belongs only to elected officials. They become, in effect, civil servants with the power to tax and spend, and as civil servants, they ought to be elected through the political process instead of being selected by the stockholders of private business firms.<sup>43</sup>

Friedman’s points that these company leaders are acting as unelected civil servants and that they may lack the necessary expertise to tax and spend effectively deserve serious consideration. The same view is expressed by Robert B. Reich:

Corporate executives are not authorized by anyone—least of all by their consumers or investors—to balance profits against the public good. Nor do they have the expertise for making such moral calculations. That’s why we live in a democracy, in which government is supposed to represent the public in drawing such lines.<sup>44</sup>

In contrast to Friedman, who believes that CSR infringes on the proper role of business, Reich’s complaint is that the promotion of CSR diverts attention from a role that government ought to play.

However, both of Reich’s concerns can be allayed by observing that, in truth, company executives have very little discretion in pursuing CSR. The CSR agenda is set largely by outside groups, which exert the pressure of public opinion on companies, and by a company’s own consumers and employees, who express their desire for socially responsible behavior by their market decisions to buy a company’s products or to accept employment. In both a democracy and a market, the people are the ultimate decision makers; in the one they make decisions with their vote, and in the other, with their buying choices. Although companies may lack expertise on some matters, on others they have a great deal of expertise upon which government must rely. Furthermore, any company can acquire expertise by making the necessary investment, and many companies have discovered that new challenges require the acquisition of nontraditional kinds of expertise. For example, in recent years, companies in polluting indus-

tries have developed their own in-house expertise in pollution control.

**CRITICISM OF TAXATION ARGUMENT** Many things are wrong with the taxation argument. To say, as Friedman does, that corporate assets belong to the shareholders, that it’s *their* money, is not wholly accurate. A corporation is itself a legal entity that owns property. Shareholders exercise some control over a corporation, but the property owned by a corporation does not belong to shareholders. Even if Friedman’s assumption that CSR involves the spending of shareholders’ money is accepted, though, it does not follow that corporations have no social responsibility.

**First, managers of a corporation do not have an obligation to earn the greatest amount of profit for shareholders without regard for the means used.** A taxi driver hired to take a passenger to the airport as fast as possible, for example, is not obligated to break traffic laws and endanger everyone else on the road. Similarly, money spent on product safety or pollution control may reduce the potential return to shareholders, but the alternative is to conduct business in a way that threatens the well-being of others in society. Friedman would insist, of course, that managers carry out their responsibility to shareholders within the rules of the game, but the moral obligation of managers to be sensitive to the social impact of their actions is more extensive than the minimal restraints listed by Friedman.

**Second, the obligation of managers is not merely to secure the maximum return but also to preserve the equity invested in a corporation.** Securing the maximum return for shareholders consistent with the preservation of invested capital requires managers to take a long-term view that considers the stability and growth of the corporation. For corporations to survive, they must satisfy the legitimate expectations of society and serve the purposes for which they have been created. Friedman admits the legitimacy of acts of social responsibility as long as they are ultimately in the self-interest of the corporation. The main area of disagreement between proponents and critics of social responsibility is: How much socially responsible behavior is in a corporation’s long-term self-interest?

**Third, the interests of shareholders are not narrowly economic; corporations are generally expected by their owners to pursue some socially desirable ends.** Shareholders are also consumers, environmentalists, and citizens in communities. Consequently, they are affected when corporations fail to act responsibly. In fact, shareholders may be morally opposed to some activities of a corporation and in favor of some changes. One writer contends that “there are conventionally motivated investors who have an interest in the social characteristics of their portfolios *as well as* dividends and capital gains.”<sup>45</sup> If so, managers who exercise social responsibility are not

“taxing” shareholders and spending the money contrary to their interests but quite the opposite; managers who do not act in a socially responsible manner are using shareholders’ money in ways that are against the interests of their shareholders.

Friedman’s response is that if shareholders want certain social goals, let them use their dividends for that purpose. However, it may be more efficient for corporations to expend funds on environmental protection, for example, than for shareholders to spend the same amount in dividends for the same purpose. For these reasons, then, the taxation argument against corporate social responsibility is not very compelling. Although the rights of shareholders place some limits on what businesses can justifiably do to address major social concerns, they do not yield the very narrowly circumscribed view of Friedman and others. The managers of a business must attend to matters beyond their immediate tasks. Serving the shareholders’ interests well requires some attention to a corporation’s social responsibilities, although managers have considerable discretion in deciding how to respond to demands of other constituencies or stakeholder groups.

## 12.3: Business Case for CSR

### 12.3 Analyze the arguments that a market for virtue makes CSR a profitable strategy and a source of competitive advantage

Although moral arguments over CSR still have intellectual interest, they are largely irrelevant to today’s corporate executives, who have, for the most part, accepted the business necessity of addressing issues of social responsibility. Present-day discussions about CSR have gone beyond normative questions about the meaning and justification of CSR and focused, instead, on practical questions of implementation. *The Economist*, which has been critical of CSR in the past, now admits, “Clearly, CSR has arrived.” A 2008 special report in the magazine concluded that CSR is a source of competitive advantage by enabling companies to meet society’s heightened expectations and protect their reputations in ways that are more focused and vigorous than those in the past.<sup>46</sup> The business case for CSR, in contrast to the moral or ethical case, does not claim that it is the right thing to do but only that it is to a company’s advantage to adopt CSR. In considering this prudential argument, though, some skepticism might be in order.

At its core, the business case for CSR is the proposition that “being socially responsible is good business.” But is this always true?

There are two related arguments for the business case for CSR, which are examined here in turn.

- One argument is that CSR contributes to profitability because the market rewards responsible behavior and punishes a company’s lapses.
- The second argument is that CSR can be a source of competitive advantage.

### 12.3.1: The Market for Virtue

If CSR is profitable, then the profit opportunities in CSR should be sufficient to induce managers to lead socially responsible companies—assuming, of course, that managers are aware of the link between CSR and profitability. One obstacle to greater CSR activity may be a lack of awareness of this link. However, the profitability of CSR or the difficulties of implementing it profitably may be overestimated. David Vogel calls the power of market forces to produce CSR activities “the market for virtue.” In his view there is a limited market in support of CSR, but it “is not sufficiently important to make it in the interest of all firms to behave more responsibly.”<sup>47</sup> The existence and potential of a market for virtue can be ascertained by identifying the specific market demand and societal forces that induce managers to undertake CSR activities.

**MARKET DEMAND** In economic terms, if CSR is the supply in a market for virtue, then there must be some demand for it. The demand, if it exists, comes from customers, employees, investors, and other groups that are willing to express their desire for CSR in the marketplace.

A number of studies show that many consumers in the United States and Europe say that they would pay more for products that meet some social test, such as being made without sweatshop labor or environmental pollution.<sup>48</sup> Some companies have responded by certifying their products as socially or environmentally responsible.

#### Examples

- The GoodWeave (formerly Rugmark) label informs consumers that a handmade carpet was not produced with child labor.
- The FSC label, issued by the Forest Stewardship Council, attests that lumber was harvested from sustainable forests.
- Certified conflict-free diamonds can be purchased by consumers who want to avoid supporting wars in Africa that are financed by the diamond trade.

Similarly, some employees seek jobs that are socially constructive. Many college students upon graduation have taken the Graduation Pledge of Social and Environmental Responsibility, which reads, “I pledge to explore and take into account the social and environmental consequences of any job I consider and will try to improve these aspects of any organization for which I work.” Companies that are known for social responsibility may be more attractive to the job candidates that they seek.

Investors are registering their concerns about the social impact of business by engaging in *socially responsible investment* (SRI). SRI mutual and retirement funds screen their investments to remove companies in objectionable industries, commonly tobacco, alcohol, and gambling (negative screens) and, sometimes, to select exemplary companies (positive screens). Some SRI funds also practice *investor advocacy*, whereby they use their position as shareholders to pressure companies' management and also to seek change through shareholder resolutions. A few funds engage in *community investment*, whereby they invest in worthwhile community activities that may not easily obtain conventional financing. A study by the Forum for Sustainable and Responsible Investment found that at the beginning of 2104, \$6.57 trillion in U.S.-domiciled assets was invested according to SRI principles.<sup>49</sup> This amount represents a 75 percent increase over the \$3.74 trillion invested in 2012. The corresponding figure in Europe for 2012 was 2.3 trillion euros.<sup>50</sup>

## WRITING PROMPT

### Recent Growth in SRI

What is the significance of this increase in socially responsible investments? Do you think SRI practices would grow in popularity if they did not provide a good rate or return to investors? Would you expect these types of investments to be riskier than others? why or why not?

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**SOCIETAL FORCES** The market for virtue responds not only to purely market demand but also to broader societal forces. Perhaps the most significant societal force pushing companies toward greater CSR is the explosive growth of nongovernmental organizations or NGOs. These advocacy groups, which range in size from such giant international organizations as Greenpeace and Oxfam to very small local operations, are generally focused on specific issues, mainly human rights, the environment, and public health. Some NGOs monitor particular industries or companies.

**NGO example:** Walmart's activities are closely followed by Walmart Watch, which is a project of the Center for Community and Corporate Ethics.

NGOs are supported largely by contributions from organizations and private individuals who want corporations to be more socially responsible, and much of their success results from the ability of NGOs to create adverse publicity about corporate targets.

Some companies and industries have organized to support CSR. The organization Business for Social Responsibility, whose membership is open only to companies, serves to help its members "integrate sustainability into

business strategy and operations." Companies That Care is an organization of businesses that encourages employers to act responsibly toward employees and the community.

**Industry example:** One example of industry CSR efforts is Responsible Care, which was established by chemical companies to improve the health, safety, and environment performance of the industry.

Moreover, some NGOs are collaborations between companies in certain industries and other groups. For example, the membership of the Fair Labor Association, which grew out of concerns over working conditions in contract factories in the shoe and garment industry, includes companies (among them, Nike, Liz Claiborne, and Patagonia), NGOs, and universities. (The latter are involved because of concerns about the conditions under which apparel with university logos is made.)

Finally, CSR is being driven by governments, which also serve as a conduit for public concerns. Government-driven CSR may be viewed as a form of company and industry self-regulation that seeks to avoid more direct government regulation. Not only may business want to avoid government regulations, but governments themselves may also promote CSR in lieu of more costly or less effective direct regulation.

### Government examples:

- The Fair Labor Association grew out of the Apparel Industry Partnership, which was convened by President Bill Clinton to address public concerns about conditions in contract factories overseas without resorting to increased government regulation.
- In 2002, the government of Great Britain, under Prime Minister Tony Blair, established the post of Minister for Corporate Responsibility in an effort to make the promotion of CSR a major governmental objective.

**POWER OF VIRTUE** All of these forces in support of CSR—consumers, employees, investors, NGOs, peer companies, and government—are present in the marketplace, as well as in the social and political environment in which corporations operate. However, the power of these forces on corporate behavior remains to be determined. Hence, the question:

How effective is the market for virtue in promoting CSR?

There is scant evidence that the economic choices of consumers, employees, or investors have much influence on corporate decision making. The most powerful factor is the ability of activists to damage the reputation and brand name of companies. The companies most likely to be targets of activists and hence to respond to market forces are those with valuable brands that are engaged in activities that raise concerns about human rights, the environment, and public health. These companies are concentrated in certain industries, such as those shown in Table 12.2.

**Table 12.2** A Watch List of Industries and Companies

Check your awareness of the public's issues with the industries listed below. What is a main concern regarding the business activities in these industries? What are some representative companies and why are their activities closely monitored by the public?

Industries	Problem(s)	Companies
Consumer goods: shoes, apparel, and household products	Unfair labor practices in contract factories overseas.	Nike, Gap, Walmart
Petroleum, timber, and mining	Environmental harm	Shell, Home Depot, Rio Tinto
Food and beverage	Raw materials are sourced from less-developed countries.	Starbucks, Nestlé, Coca-Cola
Tobacco and fast foods	Tobacco-related deaths and obesity	Altria (Philip Morris), Kraft, McDonald's

Although the impact of the market for virtue is limited in both power and scope, the effect is not insignificant, and for many of the companies most negatively affected, the change in their attitude and approach to CSR has been profound.

In the contemporary world, corporate managers are forced, more than ever before, to deliver value to shareholders. Their discretion to devote corporate resources to good causes is very limited. However, the pressures for CSR are among the factors that managers must respond to in their pursuit of profit. Insofar as there is a market for virtue, the question confronting managers is not whether to make a trade-off between social responsibility and profitability but the extent to which attending to CSR is necessary for making a profit. Ironically, Milton Friedman's fear was that unrestrained managers would use their discretion to squander corporate resources for feel-good causes. The reality today is that highly constrained managers with little discretion are being led by a market for virtue to engage in some socially responsible behavior.

### 12.3.2: Competitive Advantage

In mature efficient markets, it is very difficult for companies, especially those producing basic commodities, to gain a significant, long-term competitive advantage. Any difference that will enhance a company's products in a crowded, noisy market is a valuable corporate asset. Although competitive advantage has many sources, a strategy that incorporates social responsibility is one. Even for companies that are responding to outside pressures in the market for virtue, competitive advantage can be gained if a CSR program is also integrated into the company's strategy so as to confer a competitive advantage.

**STRATEGIC CSR** As Michael E. Porter and Mark R. Kramer observe, "A firm that views CSR as a way to placate pressure groups often finds that its approach devolves into a series of short-term defensive reactions—a never-ending public relations palliative with minimal value to society

and no strategic benefit for the business."<sup>51</sup> The alternative is to be strategic about CSR and to find ways to gain a corporate benefit along with a public good. CSR can provide a win-win opportunity, in which a company and society can create shared value. This can be done, Porter and Kramer claim, if companies bring to CSR the same analytical tools they bring to the rest of their operations. They write,

The fact is, the prevailing approaches to CSR are so fragmented and so disconnected from business and strategy as to obscure many of the greatest opportunities for companies to benefit society. If, instead, corporations were to analyze their prospects for social responsibility using the same frameworks that guide their core business choices, they would discover that CSR can be much more than a cost, a constraint, or a charitable deed—it can be a source of opportunity, innovation, and competitive advantage.<sup>52</sup>

The importance of CSR as a source of competitive advantage is all the more important given the difficulty in the present-day global economy of finding any means to differentiate a company and its products from competitors. As traditional sources of competitive advantage such as financial capital, technology, and location become less significant, David Hess, Nikolai Rogovsky, and Thomas Dunfee observe that in response, "senior management is searching for new, hard-to-imitate, less-tangible sources of competitive advantage." These "soft sources," they note, "may include the benefits achieved through the successful implementation of corporate social initiatives."<sup>53</sup>

**EXAMPLES OF SUCCESS** Companies may be able to gain a competitive advantage from engaging in CSR activities either by locating opportunities in their standard business operations or by transforming the competitive environment to create new opportunities. As an example of the former, Porter and Kramer cite the experience of Nestlé in India, where the company built a dairy in an area of severe poverty.

**Nestlé's dairy operations:** Finding that the supply of milk from local farmers was of low quality and uneven quantity, Nestlé sent specialists to help the farmers produce better milk in higher quantities by improving their cow's health and diet. The company also provided financing and technical assistance to dig wells for irrigation and to increase crop yields. The result was not only to provide the dairy with an abundant, stable supply of high-quality milk but also to improve the standard of living in the area's villages significantly. A program that enabled Nestlé to operate successfully also had a collateral benefit for the communities on which the company depended. Nestlé has applied the lessons it learned from its dairy in India to the sourcing of other commodities, such as coffee and cocoa, in other parts of the world.

Whole Foods Market is an example of a company that created a successful business model with social values at its core.

### Case: CSR at Whole Foods

Founded in 1980 as a single organic food store in Austin, Texas, Whole Foods Market is unlike a conventional grocery chain that sells basic commodities at low margin. With the motto “Whole Foods, Whole People, Whole Planet,” the company seeks to implement a “new vision of the future by changing the way we think about the relationships between our food supply, the environment, and our bodies.”<sup>54</sup> Implementing this vision consists of meeting the needs of all its stakeholders. For customers this means not only satisfying but also “delighting” them by providing them with wholesome food at good value and educating them about nutrition and the benefits of organic foods. Whole Foods employees, who work in self-directed teams, are encouraged to take responsibility for the success of the business and develop their own potential. The company is committed to supporting local growers and to sourcing from organic farmers who practice sustainable agriculture. Among the steps Whole Foods takes to protect the environment are a reduction in the use of packaging and the sale of less toxic cleaning products. The company supports local communities by contributing 5 percent of its after-tax profits to worthy causes.

In contrast to Nestlé in India, where the company found a way to benefit itself and the community in the ordinary course of doing business, Whole Foods Market has promoted important social values by making them a part of their strategy for attracting customers to their products, as well as employees to its workforce, and for distinguishing the company from its competitors. By seizing on people’s concern for organic food, sustainable agriculture, and environmental protection, Whole Foods has created a business model that allows it to deliver greater value to its customers than its competitors are able to do—and to charge higher prices because of this added value. The strategy of Whole Foods also confers an enduring competitive advantage that other companies cannot easily duplicate.

This use of CSR to obtain competitive advantage may not be feasible for many companies and industries; indeed, it may be a niche strategy that is suitable only under limited circumstances. However, most large corporations profess a commitment to CSR and engage in a wide range of activities in the belief that they offer some competitive advantage.

#### WRITING PROMPT

##### Finding Beneficial Opportunities for CSR

Is it possible for a company to benefit both society and itself, as Nestlé has done in India, by reducing the cost of doing business? Describe a situation where cost-cutting could benefit society and/or the environment, as well as the company. Or, describe an application of CSR principles that could enable a company to create a profitable niche for itself, like Whole Foods.

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## 12.4: Implementing CSR

### 12.4 Summarize the important aspects of successful CSR programs, the difficulties with measuring the social performance of companies, and various attempts at measurement

If either of the two arguments for CSR—the argument from the market for virtue or the argument about competitive advantage—is persuasive to a company’s management, a large gulf still remains between making a commitment to CSR on the one hand and formulating and implementing a successful CSR program on the other. Every socially responsible company faces two key questions:

What CSR activities should be undertaken, and how can these activities be undertaken effectively?

Although a few exemplary companies provide inspiring stories and attest to the potential benefits of CSR, their programs may offer little guidance to managers who are trying to decide what their own company should do about CSR. Once companies have developed a significant CSR program, they are further challenged by outside groups about the reporting of their CSR performance. Activists are urging companies to report their CSR performance in much the same way that they report their financial performance. As a result, some companies now engage in so-called triple-bottom-line accounting: financial, social, and environmental. Questions remain, however, about whether such accounting is worth doing and, indeed, whether it can be done meaningfully.

### 12.4.1: Program Selection and Design

The guiding principles of strategic CSR are that there is an interdependence between business and society and that, as a result, there are opportunities for mutual benefit. The search for opportunities in this realm of mutually beneficial interdependence must be approached like any other business problem. As Porter and Kramer express the point, “To put these broad principles into practice, a company must integrate a social perspective into the core frameworks it already uses to understand competition and guide its business strategy.”<sup>55</sup> A survey of corporations with successful CSR programs that produce genuine social benefits while serving corporate interests yields some valuable guidance about the selection and implementation process.

**First, one important aspect of CSR is the management of reputation risk.** Companies, especially those with strong brand names, need to identify the activities that could be the target of moral criticism. An analysis of these reputation risks should focus specifically on business activities that have impacts on such ethically sensitive matters as human rights, the environment, and public health. Many reputation-threatening issues are easily anticipated, such as the

environmental risk of mining, but others are emerging issues that companies fail to anticipate in a timely manner. For example, Nike was slow to accept responsibility for the treatment of workers in its contract factories abroad. McDonald's anticipated environmental concerns about food packaging and addressed the subject effectively, but the company was caught off guard by two emerging issues, the alleged destruction of Amazon rain forests from cattle raising and the company's use of trans fats in its products. Even spurious issues are better handled if they are anticipated and addressed quickly. For example, Coca-Cola denies charges that its operations in India have damaged underground water supplies, but its response to this issue has taken considerable effort and has not allayed all criticism (see Case: Coca-Cola's Water Use in India).

**Second, CSR activities that are closely linked to a company's employment needs or product sales yield easily identifiable and measurable benefits.** For example, both McDonald's and Marriott, which have a great need for large numbers of entry-level workers, conduct extensive training programs that help workers who have never held a job to learn valuable work skills and attitudes. Many companies in the computer industry, including Microsoft, IBM, and Intel, have supported projects in computer literacy and science education among students throughout the world. Such efforts are clearly linked to these companies' interest in the spread of computer usage and the development of technology. In a similar manner, Home Depot, whose sales depend on home improvements and repairs, offers many programs to support local communities, including Home Impact Grants to nonprofit organizations that promote affordable housing.

**Third, the most successful CSR programs make use of a company's mission and core competencies.** United Parcel Service, with its extensive expertise in logistics, is committed to transporting relief supplies to war-torn and disaster-stricken areas. This valuable service not only fits with the company's core competency in shipping goods but also improves the company's capabilities. Coca-Cola, which is Africa's largest employer, announced in 2001 that it would help combat AIDS on that continent by using its expertise in advertising and distribution to educate people about the disease and deliver literature, condoms, and testing kits where needed.<sup>56</sup> In this effort, Coca-Cola is making use of its formidable marketing ability, which is capable of rolling out a new advertising campaign in 50 countries at once, and its extensive distribution system, which operates in every African country except for two and which supplies soft drinks to even remote villages. The company is not acting alone in fighting AIDS but is partnering with existing organizations, including Unaid, a United Nations agency. A Coca-Cola spokesperson observed, "We don't intend to create programs, but we'll help existing ones." He added, "We don't kid ourselves—we're a beverage company."<sup>57</sup>

**Fourth, truly strategic CSR identifies opportunities that fit with a company's strategy.** Only a few companies can develop a comprehensive strategy around social values in the way that Whole Foods Market has done. However, McDonald's support for Ronald McDonald House Charities, which provides accommodations near hospitals for the families of seriously ill children undergoing treatment, advances the company's strategy of promoting a family-friendly atmosphere in its restaurants.

#### Case: BP and "Beyond Petroleum"

Although many companies have responded to environmental concerns by reducing emissions and energy use, BP, formerly British Petroleum, put the environment at the core of its strategy of reinventing the energy business. Instead of seeking merely to produce oil and gas more efficiently, BP reconceived itself, under the leadership of Sir John Browne, as an energy company, with the motto that BP stood for "Beyond Petroleum," and committed the company to the goal of researching new energy sources.

BP's strategy of reinventing the energy business provided little protection against damage to the company's reputation, as well as its pocketbook, when, on April 20, 2010, a gas explosion occurred at the Deepwater Horizon drilling rig in the Gulf of Mexico. In the 87 days it took BP to cap the well, nearly 4 million barrels of oil were discharged into the gulf waters, washing up along the coastline in four states and causing extensive damage to the environment and to residents' businesses. In a court trial, a judge found BP to be "grossly negligent" in cutting corners in safety measures in order to reduce costs and declared that these actions "evinced an extreme deviation from the standard of care and a conscious disregard of known risks."<sup>58</sup> In addition to payments of \$42 billion by BP to cover costs of the cleanup, the company still faced, in 2015, potential fines of \$13 billion. One lesson to be learned from the BP Deepwater Horizon disaster is that social responsibility must be manifested in all of a company's activities and not confined to a few matters.

**Fifth, successful CSR programs incorporate stakeholder engagement or dialogue.** Outside groups can be a resource not only in expanding a company's capabilities—as witness Coca-Cola's decision to partner with other organizations in Africa to fight AIDS—but also in understanding the needs and outlooks of others and engaging them in the pursuit of mutual benefit. According to the World Business Council for Sustainable Development, which was formed in 1995 by the CEOs of 200 global companies to address environmental issues,

The essence of corporate social responsibility is to recognize the value of external stakeholder dialogue. Because of this, we place stakeholder engagement at the center of CSR activity. CSR means more than promulgating a company's own values and principles. It also depends on understanding the values and principles of those who have a stake in its operations.<sup>59</sup>

**Figure 12.2** Guidelines for Strategic CSR Programs

Guideline 1	Guideline 2	Guideline 3	Guideline 4	Guideline 5
Identify and manage risks to the company's reputation, based on public criticism of activities in which the company engages.	Look for opportunities to apply CSR while addressing business needs, particularly with regard to employees (training) and increased sales (developing customer base).	Develop goals that build on the company's core mission, operational strengths, and operational strengths, and areas of expertise, or seek out partner organizations that need what the	Identify opportunities that fit with the company's existing business strategy, and apply related CSR principles across all of the company's operations.	Regularly engage with stakeholders and encourage dialogue as a part of the program.

If strategic CSR involves the discovery of mutually beneficial activities that arise because of the interdependence of business and society, then the mutual benefits are more likely to arise from the interaction of a company and outside groups, with respect on both sides, and not merely from business acting alone.

**SUMMARY OF CSR GUIDELINES** Use Figure 12.2 to review these important aspects of successful CSR programs and how they provide a framework for strategically developing a program.

### WRITING PROMPT

#### CSR and the Size of Business

The companies provided as examples thus far are large, multinational corporations. Are the discussed program characteristics and guidelines applicable to smaller companies or companies with fewer resources? Explain how the scale of a company's business or operations can be taken into account when designing a CSR program.

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## 12.4.2: Reporting and Accountability

Corporate social responsibility has value only if it actually has the social benefits that companies claim and outside groups want. The demand for some measurement of social performance has given rise to a movement that is variously described as social and ethical auditing, accounting, and reporting (SEAR) and triple-bottom-line accounting (3BL). The impetus for this movement comes from several sources.

1. First, companies themselves, which are accustomed to measuring all aspects of their performance, seek to evaluate the benefits of their CSR programs. They do

this not only to ensure that projects are properly selected and implemented but also to demonstrate the value of CSR activities to shareholders and the public.

2. Second, there are several influential rating organizations that rank companies on social performance. The most prominent rankings are the Dow Jones Sustainability Index, FT-SE4Good Index, and the MSCI KLD 400 Index. Although these indexes are intended primarily for use by investment managers, they are also widely followed by the public.

3. Third, socially responsible investment funds generally apply their

own measures to company performance in addition to using the rankings of rating organizations.

4. Fourth, there is a substantial body of academic research devoted to measuring corporate social performance and comparing this with financial performance. In general, these studies, which use various measurement systems, have found a small but statistically significant positive correlation between social and financial performance.<sup>60</sup> These studies raise issues of method and interpretation, however, especially about the direction of causation. That is, does greater social performance lead to greater profitability, or are more profitable companies better able to afford more social performance?

Regardless of why CSR is measured, the results are only as reliable as the data and their interpretation.<sup>61</sup> The information used for measuring social and environmental performance is very diverse in kind and comes from a variety of sources. Not only may different attempts to measure performance use different data, but also the data may be given different weights and interpretations. As a result, companies are able to select data and interpret them in ways that yield virtually any desired result and prevent meaningful comparison between companies.

The root of the problem is that unlike financial data, which are recorded, reported, and verified according to uniform accounting and auditing standards, information about social and environmental performance is not easily subjected to the same kind of precise treatment. Several organizations have attempted to make social reporting more like financial reporting. In particular, the Global Reporting Initiative (GRI) and the Institute of Social and Ethical AccountAbility (ISEA) have developed complex and specific guidelines for measuring social and environmental performance. ISEA also offers a certification, the AA1000, that is similar in concept to awards for quality control, such as the ISO 9000.



Despite the problems with SEEAR and 3BL, corporations annually publish glossy documents that detail their good works, and the various indexes and rankings continue to be produced with great fanfare. Although the amount and reliability of data are increasing and methods of accounting and auditing are growing more sophisticated, social or ethical reporting will never be as meaningful as financial reporting. In particular, the idea of a social bottom line that is comparable to a financial bottom line is unattainable in principle simply because there is no common unit of measurement for social benefits that corresponds to the dollars and cents of financial accounting.<sup>62</sup> Moreover, a financial bottom line subtracts expenses from revenues to yield net income, whereas a social bottom line

consists mainly of a number of beneficial activities that represent a sum total of good done by a company. Thus, the idea of 3BL can probably be nothing more than a clever turn of phrase.

Even if social or ethical reporting cannot be fully comparable to financial reporting, the recent interest by companies and the public in gathering information about CSR and publishing the results is probably overall a worthwhile development. Although some companies might be hypocritical in their use of SEEAR or 3BL, most appear to be genuine in their commitment. Such reporting is likely to encourage greater corporate social performance and also to increase the transparency of CSR activities, which permits closer scrutiny of companies' social performance.

### Simulation: CSR at Costco

Costco Wholesale Corporation is the third largest retailer in the United States, selling a wide range of nationally-branded and private-label food products, household items, and electronics to its loyal members. Corporate social responsibility at Costco is born out of its mission to respect its stakeholders and maintaining an advantage in an increasingly competitive retail market. Its initiatives focus on the protection of the natural environment and the implementation of sourcing practices to assure that its products are manufactured under fair and humane conditions.<sup>63</sup> In the first area Costco has sought reductions in its reliance on carbon-emitting energy to minimize its contribution to global climate change. In the second area Costco seeks to ensure that the consumer electronics products sold in its stores minimize the use of minerals from so-called "conflict" zones in Africa that are controlled by regimes known to violate human rights.

How can Costco measure and report the effectiveness of its initiative to reduce its carbon emissions?

Costco can calculate the amount of carbon emissions that are attributable to the activities undertaken by its employees in the course of business.

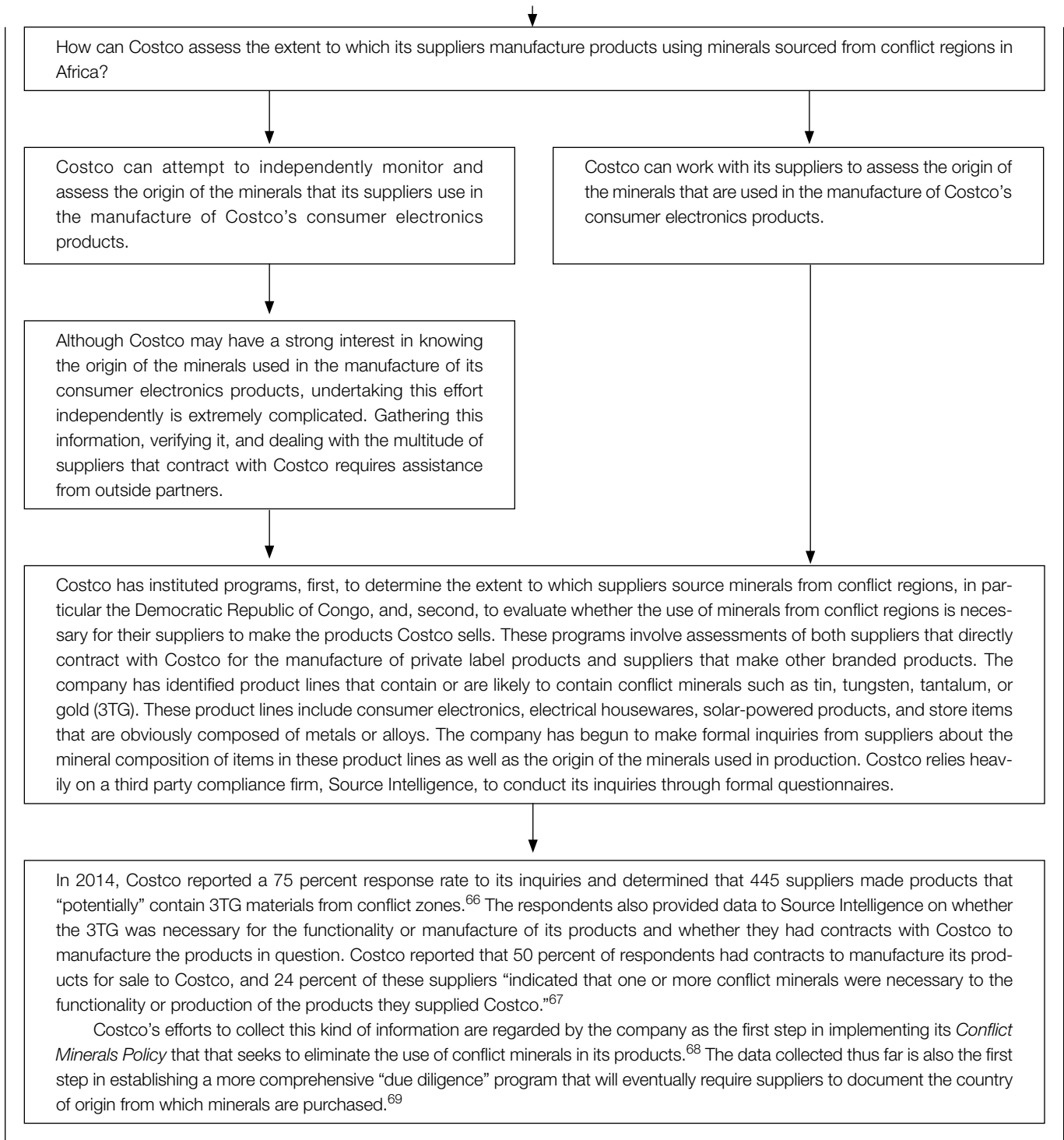
Costco can calculate the amount of carbon emissions that are attributable to the activities of other partners that support Costco's business.

Costco actually measures its carbon "footprint" by including both the activities of its employees as well as supporting partners. It divides its carbon emissions into two categories, direct and indirect emissions, and then uses concrete and estimated measurements of different emission sources to quantify the annual tonnage of carbon attributable to Costco.<sup>64</sup>

Direct emissions of carbon are tied activities that are undertaken by Costco employees in the course of its day-to-day business operation. This category includes the use of natural gas and propane used for heating or food processing, the amount of diesel burned by Costco's truck fleets and on-site equipment, the projected leakage of refrigerants from air conditioning units, and the use of jet fuel and gasoline associated with company-sponsored travel.

The indirect carbon emissions associated with Costco's operations are at this point in time tied exclusively to the amount of electricity that Costco purchases from utility companies. These indirect emissions, which vary according to the methods that regional utilities use to produce electricity, make up the vast majority of Costco's measurable carbon emissions. In its most recent Corporate Sustainability Report, for example, 74% of Costco's carbon emissions were tied to electricity use. One might expect that in the future Costco's interest in reducing indirect carbon emissions may extend to measuring the carbon emitted by its suppliers to produce Costco's retail items as well as the distance traveled by customers to their stores.

Costco's latest Corporate Sustainability Report states that the aggregate amount of direct and indirect carbon emissions increased by 9.32 percent between 2009 and 2013 but that Costco's emissions as a percentage of sales revenue fell from 2.3 percent to 1.8 percent during the same period of time.<sup>65</sup>



## 12.5: Business with a Mission

### 12.5 Compare how nonprofit and for-profit social enterprises operate and can compete successfully in the marketplace

Most businesses proclaim a mission. Often set forth in an explicit statement, a mission serves as a unifying vision of the benefits that a corporation creates for society. Mission

statements, which are prominently displayed in company documents and on websites, are an effective means of communicating and building relationships with employees, consumers, investors, and the general public.

Although the objective of a corporation is commonly described as making profits for shareholders, no profit can be earned without providing some economic good—which is to say, some product or service. This good must fulfill a need, expressed as market demand, and be preferred by consumers over the offerings of competitors. Fortunately, most economic

goods can be provided in sufficient quantity and quality and at affordable prices to meet market demand and thus satisfy people's needs through the marketplace. In a market economy, we rely on for-profit business for the fulfillment of most economic needs, and companies benefit society by each pursuing a mission to fulfill some specific need. Thus, in one sense, all businesses are, of necessity, mission-driven.

It is commonly recognized that standard for-profit businesses are not able to fulfill all economic needs. An obvious failure occurs when companies are unable to offer goods at prices that everyone can afford and still make a profit. The market can respond to low purchasing power by reducing quantity or quality. For example, automobiles are manufactured in different price ranges with corresponding differences in quality. However, some essential goods such as housing, education, and health care cannot be produced by business in sufficient quantity and quality and at prices that can be afforded by everyone. The result is that some goods are simply unaffordable for some people, who are consequently forced to do without, unless they can be provided by some means outside the marketplace. In addition to unaffordable goods, public goods, such as roads and parks and police and fire protection, are necessities that cannot be fully provided by business and are left mainly for government to provide. Both unaffordable goods and public goods are examples of what economists call *market failures*.

Some goods are so critical for individual well-being that, in cases of market failure, a humane society provides them to people in need outside the market, mainly through nonprofit, donor-supported organizations and/or through tax-supported government welfare services. Corporations also help meet some pressing social needs through their various social responsibility programs. However, in recent years, a new type of organization, the *social enterprise*, has developed to meet critical unmet social needs. Operating alongside traditional nonprofit organizations, government welfare agencies, and corporate social responsibility programs, social enterprises have the mission of a traditional nonprofit organization but differ from them by the adoption of business concepts and methods. Social enterprises operate *like* a business but with the *non-business-like* mission of meeting essential social needs that standard businesses, operating in a market, do not and perhaps cannot provide.

### 12.5.1: Social Enterprise

Definitions of a social enterprise vary widely, due mainly to the diversity of forms that such organizations take. The following definition is typical:

A social enterprise is any business venture created for a social purpose—mitigating/reducing a social problem or market failure—and to generate social value while operating with the financial discipline, innovation and determination of a private sector business.<sup>70</sup>

In this definition, the key concepts of “social purpose” and “social value” are combined with the chief characteristics of the standard business corporation. Discipline suggests careful planning and cost control, while innovation is the important factor of discovering new means for obtaining and utilizing resources. Because a social enterprise operates like a business in a challenging market where traditional businesses have failed or declined to enter, determination is essential.

The needs that social enterprise seeks to provide are among the most basic: employment, education, housing, nutrition, health care, family well-being, and community development. Most people satisfy these basic needs with their own resources, but some are unable to do so for many reasons, including poverty, disability, addiction, criminal record, inadequate education, broken homes, and distressed communities. The urgency of meeting these needs is undeniable, but is seeking to meet them an appropriate or even a feasible task for a business? Both community-based nonprofit organizations and government welfare agencies are dedicated to providing critical social services. They have not only the expertise to realize their mission but also the resources: Nonprofits are supported by donations from the public, while government has the power of taxation. Insofar as operating like a business creates greater efficiency, both nonprofits and governments can, and have, become more businesslike without actually becoming businesses. This raises the following question:

What kind of a business is a social enterprise?

Social enterprises take two basic forms: nonprofit and for-profit.

**NONPROFIT SOCIAL ENTERPRISE** A social enterprise can be a nonprofit organization whose main source of revenue is not donations but earned income. Called variously “enterprising nonprofits”<sup>71</sup> or “commercial nonprofits,”<sup>72</sup> these organizations offer products or services in the market in order to generate sales income that substitutes for or, ideally, supplements donations. The National Geographic Society, for example, generates considerable revenue from its iconic magazine, as well as from books, maps, clothing, luggage, gadgets, home décor, jewelry, and a plethora of other enticing goods. The Society’s website states, “Your online purchases help fund our nonprofit mission of research, education, conservation, and exploration.” In 2012, the Society received approximately two-thirds of its \$445 million in support from its revenue-generating publishing and educational programs and less than a third from contributions and membership dues.<sup>73</sup>

Although The National Geographic Society has a worthy mission and is an exemplar of an enterprising or commercial nonprofit, it would not ordinarily be classified as a social enterprise since it does not provide critical social benefits for underserved populations. A better example of a nonprofit social enterprise is Benetech,

which was founded by a Caltech graduate, Jim Fruchterman. In the 1970s, he developed a pattern recognition technology that could transform text into speech. The idea of creating a reading machine for the blind inspired Fruchterman to search for other ways in which technology could be employed to improve the lives of people. Finding that investors had little interest in technology that would not generate large profits, he decided to establish a nonprofit organization with the mission to develop “innovative and effective technology applications for unmet social needs.”

The major focus of Benetech is global literacy, which it advances by developing technology that provides access to printed material for people with visual impairments and learning and physical disabilities. One program, Bookshare, produces books in the most suitable format for use on available tools, including smartphones and digital tablets. The company also has technology for enabling human rights and environmental activists to collect, store, and share data. The division Benetech Labs seeks to develop additional technology for advancing the company’s mission. In 2013, approximately 12 percent of Benetech’s revenue came from contributions; the remainder of its income was earned from sales of its products and services, with the largest portion (78%) coming from the Bookshare program.<sup>74</sup>

**FOR-PROFIT SOCIAL ENTERPRISE** The for-profit social enterprise is a relatively recent development, and examples of it tend to be small, local companies with little visibility. Iconic companies like Patagonia and Ben & Jerry’s are exceptions.

- Under the leadership of founder Yvon Chouinard, the high-end outdoor clothing company Patagonia pioneered the use of sustainably produced materials, actively promoted recycling, and practiced responsible manufacturing. The company’s commitment to the environment as expressed in its mission statement is to “use business to inspire and implement solutions to the environmental crisis.”
- Ben & Jerry’s ice cream is a controversial example because of its acquisition in 2000 by the giant multinational corporation Unilever. However, in the 1990s, the company became legendary for its treatment of employees, protection of the environment, and support of worthy causes. One founder, Ben Cohen, described the company as “an experiment to see if it was possible to use the tools of business to repair society.”<sup>75</sup>

Among better known for-profit social enterprises are Toms Shoes and Warby Parker, both of which employ the “buy one, give one” business model. For each pair of shoes (Toms) or eyeglasses (Warby Parker) sold, the company donates another pair of shoes or eyeglasses for the

benefit of the needy in developing countries. The two companies differ, however, in their use of this innovative model: Whereas Toms merely gives away shoes, which may adversely affect a local economy (What happens to the local shoe vendor?), Warby Parker trains local people, through a nonprofit subsidiary, to start a business selling low-cost eyeglasses.<sup>76</sup> Both companies also use their profits to make charitable donations to a wide variety of worthy causes.

Some for-profit social enterprises market conventional products, such as apparel, shoes, and eyeglasses, but operate in a socially beneficial manner (Patagonia) or else attract consumers by building a social benefit into their business models (Toms Shoes and Warby Parker). Other social enterprises meet social needs by hiring and training disabled or disadvantaged people who would otherwise be unemployed. Many of these for-profit businesses are subsidiaries of nonprofit organizations, which consequently are said to have a “hybrid structure.” (A nonprofit subsidiary of a standard for-profit corporation is also an instance of a hybrid structure.) The world of social enterprise is also populated by a variety of businesses, both nonprofit and for-profit, which provide support services, including, most notably, financing. In particular, “impact investment” is a term applied to a growing group of funds that seek to make a positive impact on society while still obtaining market-rate financial returns.

## 12.5.2: Competing Successfully

As businesses, social enterprises must compete successfully in the marketplace with already established traditional nonprofits and government welfare services, which may be pursuing the same social mission. Nonprofits are required by law to have a socially beneficial mission as a condition of their privileged tax status, but a for-profit business can also pursue a social mission. Indeed, a for-profit business can be founded for any legal objective; the objective of making a profit is not legally required. However, all organizations, whether nonprofit or for-profit, have one absolute practical requirement: *They must generate enough revenue to cover their costs, including the cost of capital.* Any organization that does this can stay in business; those that fail—and, of course, many do—will go out of business.

The challenge for enterprising or commercial nonprofits, as well as for-profit social enterprises, is to generate sufficient revenue in a market with formidable competitors. Donor-supported nonprofits receive revenue in the form of philanthropy from community members, while government welfare services are tax-supported. Enterprising or commercial nonprofits, which seek to generate earned revenue, can also receive donations, and many do. However, for-profit social

enterprises largely forgo donations entirely and, consequently, must generate most of their revenue from the sale of products or services. Merely having a worthy mission will not protect a revenue-dependent organization from failure; it must, like any business, generate enough revenue to cover all its costs.

**COMPETING AS A NONPROFIT** The nonprofit form is ideally suited for an organization with a mission. Any nonprofit has the opportunity to supplement donations with sales revenue (although it will be taxed on income unrelated to its mission). An enterprising or commercial nonprofit can survive in a highly competitive market only by offering products or services that are equal or superior to those of competitors. In some cases, survival is possible due to a lack of competitors (Benetech, for example, found new, unserved markets). In other cases, the goods offered by a nonprofit may be preferred by consumers because the sale supports a mission they favor (Girl Scout cookies, for example). The nonprofit form is so well suited to the pursuit of a mission that one may wonder:

Why would the founders of a mission-driven organization choose the for-profit form and seek to operate it as a business, especially since this form largely precludes access to charitable donations?

In order for for-profit social enterprise to make economic sense, the incorporation of a mission-driven organization in the for-profit form must enable it to have greater social impact than would be possible for a nonprofit organization with the same mission. Put simply, a for-profit social enterprise is possible—that is, has a competitive advantage in the market—only if its mission can be pursued more effectively as a business than as a charity. From an economic point of view, a for-profit mission-driven social enterprise can gain a competitive advantage in two ways: It can gain access to greater resources and/or it can utilize the available resources more effectively in making an impact. Both of these factors—access to and utilization of resources—depend on a third, critical factor in social enterprise, namely, *innovation*. Social enterprise is, above all, a matter of being innovative in meeting critical human needs.

**COMPETING AS A FOR-PROFIT** The main benefit of for-profit social enterprise over its nonprofit competition is access to equity capital and other kinds of return-seeking investment. Nonprofits may obtain loans on which they pay interest, but this source of funding is severely limited. Equity capital, by contrast, is available only to for-profit corporations inasmuch as equity investors are compensated with profits, which, by definition, cannot be made by nonprofit organizations.<sup>77</sup>

The benefits of equity capital for social enterprises are numerous. The more capital available to a business, the

greater the returns on profitable investments and the more quickly these returns can be realized. In particular, equity capital enables a social enterprise to grow—to “scale up” in the jargon—and implement innovative ideas more effectively for greater impact. Nonprofits, by contrast, typically grow slowly and are unable to change quickly due to their reliance on donations. Nonprofits also face pressure to use donations for their intended purpose and not, for example, to invest in building capacity or to attract the best talent with higher pay. These benefits of equity capital are enhanced by the increasing interest of investors in making an impact along with gaining financial return in the movement known as “impact investment.” Social enterprises also benefit from the development of innovative forms of capital that meet the special circumstances of mission-driven organizations, as well as the unconventional interests of impact investors.

In their competition with standard for-profit businesses, social enterprises benefit from access to many of the resources of traditional nonprofit organizations. Most notably, the attractive missions of both nonprofits and for-profit social enterprises lead to fruitful collaborations with individuals and community groups, which willingly lend their talents, creative ideas, and organizational capabilities. Governments are also more willing to work with mission-driven organizations, whether nonprofit or for-profit, than with business corporations in joint efforts to provide social benefits. Indeed, governments are major purchasers of the goods and services provided by social enterprises. For example, some municipalities favor suppliers that employ persons with disabilities, who might otherwise require greater welfare assistance.

In addition to accessing more resources, social enterprises can gain competitive advantage by utilizing them more effectively. This task is served mainly by innovation.

### Examples

- Jim Fruchterman’s discovery of a pattern recognition technology had many applications—missile guidance systems was one—but only he had the idea of using it in a reading machine for the blind. However, developing the idea into a product—and also founding a company, Benetech, for bringing the idea to market, as well for making new discoveries and creating new products from them—was highly innovative.
- Another example of a now commonplace idea that was novel at the time of development is *microfinance*, for which Muhammad Yunus and the Grameen Bank of Bangladesh were awarded the Nobel Peace Prize in 2006. The idea of making loans in small amounts to the very poor is not original, but in the face of critics who argued that it could never be done profitably, Muhammad Yunus devised a

method to make it work and, in the process, created a major banking institution, which today has many imitators.

### 12.5.3: Mission and Trust

As previously noted, a for-profit corporation can have any legal objective. Thus, it can have a social mission in addition to, or even instead of, the objective of earning profits for shareholders. The objective or mission of a for-profit corporation is determined by whatever group has control. In a new enterprise or start-up, this group is the founders. As an organization grows, the mission can be maintained as long as these founders or their successors, who have control, remain committed to it.

**However, a for-profit social enterprise encounters difficulty in maintaining a social-benefit mission once it obtains equity capital from outside investors.** The source of this difficulty is that investors are reluctant to supply equity capital without obtaining some measure of control, because control is the main means by which they can ensure the profits that constitute their return. In the standard for-profit corporation, equity capital providers usually become the shareholders, with legal rights of control. In consequence, maximizing profits—which are distributed to the shareholder—investors—becomes the objective of the corporation, because this is what profit-minded shareholders want.

For a social enterprise, like any business, it is difficult to obtain equity capital without ceding some control, but once outsiders gain some control, they are in a position to compromise or even abandon the mission in favor of greater profits. That is, they could replace a social benefit with profit maximization as the objective of the social enterprise, thereby turning it into a conventional for-profit business. The main benefit of a for-profit social enterprise, namely access to equity capital, thus becomes a significant liability. This liability partially explains why many social enterprises remain controlled by a small group of investors and are not publicly traded. Smaller, like-minded groups of investors tend to remain more focused on an enterprise's social mission, as opposed to large, diverse investor groups, which typically exercise control with a view primarily to profitability.

**A second liability facing for-profit social enterprises is the loss of trust, which results from the opportunity to make a profit.** The defining feature of a nonprofit organization is what Henry Hansmann terms the *nondistribution constraint*.<sup>78</sup> Nonprofits are legally barred from distributing assets for any purpose other than the advancement of their mission. Any surplus revenues—which constitute profits in a for-profit corporation—must be retained by a nonprofit as an organizational asset. This nondistribution constraint is critical in building the trust

necessary for attracting charitable donations to a nonprofit organization. People are willing to give money to a nonprofit, not only because they want to support the mission but also because the nondistribution constraint assures them that their money will not be diverted for other purposes. Without this assurance, contributions would be more difficult to obtain.

Although for-profit social enterprises largely forgo donations or contributions, their successful operation still depends on a high degree of trust, which it must somehow obtain without the benefit of the nondistribution constraint. The need for trust arises because, more than a standard business, a social enterprise must gain the active support of its employees, the people it serves, government, and the public. An ordinary business operates mostly in a market, buying the inputs that it needs (mainly workers and raw materials) and selling the outputs (products or services) to customers. For this kind of market-based activity, little trust is required because contracts provide the necessary assurance. By contrast, a for-profit social enterprise, like a nonprofit, operates more in a community than in a market and is heavily dependent on the willing cooperation of many different groups. This willingness to cooperate would not be possible without assurance that the shared mission of the enterprise will be pursued. For these reasons, trust is essential for social enterprises, especially when they are for-profit.

**Both of these problems—preserving the mission and building trust—can be addressed to some extent by innovative forms of corporate governance.** In the United States, for-profit social enterprises can now incorporate in many states as a *benefit corporation*. A similar incorporation form in the United Kingdom is the *community interest company*. Both of these forms of incorporation require that the venture be organized primarily for a recognized socially beneficial purpose, with profit as a secondary or incidental aim. The legislation for these alternative incorporation forms also contains provisions about considering the interests of all groups in society in decision making and about reporting activities in a highly transparent manner. In addition, the designation Certified B Corporation—not be confused with the benefit corporation—is awarded by a nonprofit organization, the B Lab, for business corporations that voluntarily pledge themselves to high standards of transparency, accountability, and social performance.

The benefit corporation and the community interest company forms of incorporation serve to create trust by proclaiming a social mission and installing safeguards to maintain it. The Certified B Corporation designation seeks the same ends but without conferring any legal requirements or protections. In the United States, the need for new incorporation statutes for social enterprise was highlighted by the sale of Ben & Jerry's to Unilever, a relentlessly

bottom line-focused company. Although Ben Cohen and Jerry Greenfield expressed firm opposition to the sale, they claimed to have been forced by corporate law. In their view, the board was legally obligated to sell to the highest bidder without regard for the company's original social mission. Advocates of benefit corporation legislation argue that the outcome would have been far different had the founders been able to incorporate under more recently enacted statutes. This argument is countered, however, by claims that the board was not legally required to sell the company and that standard corporate law, judiciously applied, is sufficient for the needs of social enterprises.<sup>79</sup>

**COMPARING NONPROFIT AND FOR-PROFIT SOCIAL ENTERPRISES** The major characteristics of nonprofit and for-profit social enterprises are outlined in Table 12.3.

### WRITING PROMPT

#### Potential Advantages of For-Profits

Goodwill Industries International is a nonprofit that has been serving people with disabilities for over 100 years. In 2014 Goodwill provided job training, assistance in finding employment, and other community services to 9.8 million people in the United States and Canada. It funds its operations with sales of donated items from its chain of more than 3,000 retail thrift stores and through its shopgoodwill.com website. Could Goodwill have been as successful as it has been in pursuing its mission if it had been founded as a for-profit social enterprise?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

**Table 12.3** Nonprofit versus For-Profit Social Enterprises

How are nonprofit and for-profit social enterprises alike? How are they different? Compare the main characteristics of each type of social enterprise. Then hide the cells to quiz yourself.

	Nonprofit SE	For-Profit SE
<b>Definition</b>	A nonprofit whose main source of revenue is earned income, not donations	A business created for a social purpose, that operates in a socially-beneficial manner
<b>AKA</b>	Enterprising nonprofits, commercial nonprofits	Possible forms: <ul style="list-style-type: none"> <li>• subsidiary of a hybrid nonprofit</li> <li>• benefit corporation (community interest company)</li> <li>• Certified B Corporation</li> </ul>
<b>Example(s)</b>	Benetech (technology to aid global literacy)	Patagonia (environmentally-sustainable clothing) Toms Shoes (donates shoes to the needy)
<b>Available funding</b>	Sales, donations, loans	Sales, equity capital, impact investment
<b>Advantages</b>	Tax benefits Income from donations People have more confidence in nonprofit causes	Equity capital allows faster growth, more effective use of resources Ability to retain profit
<b>Challenges</b>	Need for innovation Pressure to use donations for given purposes Limits on spending	Need for innovation Pressure to give some control to outside investors Difficulty keeping focus on social mission over profit Loss of public trust

## Conclusion: Corporate Social Responsibility

The meaning of corporate social responsibility and the arguments for it, as well as the attitudes of business toward it, have changed dramatically over the past 50 years. The vigorous debate over the normative case for CSR gave way eventually to a wary acceptance and then an enthusiastic embrace of the business case. Along the way, the question about CSR changed from whether to how. However, whether the meaning of CSR also shifted to fit with what business was willing and able to do is an open question. What is undeniable is that, in the words of *The Economist* magazine, "CSR is thriving." CSR has become a virtual industry, with most large corporations proclaiming long lists of activities. The challenge now for corporations is to be strategic about CSR and develop programs that provide the greatest benefit for themselves and society.

The development of social enterprise shows that this challenge can be met not only by conventional CSR programs but also by new kinds of businesses that have a social mission as their very reason for existence. The challenge for society is to make demands on corporations of all kinds for greater responsibility that best utilize their capabilities and resources.

## End-of-Chapter Case Studies

This chapter concludes with three case studies.

The focus of large corporations on social responsibility may result from pressure by outside activists, as occurred at

Starbucks (“Starbucks and Fair Trade Coffee”) and Coca-Cola (“Coca-Cola’s Water Use in India”), or it may be due to the commitment of visionary inside leaders, such as Jeffrey Swartz (“Timberland and Community Service”). In all three of these cases, the changes produced by a focus on social responsibility were beneficial, both for the corporation and for society. Together, these three cases make a powerful argument for the proposition that, in Mr. Swartz’s phrase, “commerce and justice” can be successfully combined to produce enduring socially responsible corporations.

## Case: Starbucks and Fair Trade Coffee

Starbucks built a fast-growing business on a corporate philosophy of putting people first. This philosophy began with employees, providing good working conditions and treating them all with dignity and respect. Howard Schultz, the leader of the company, who bought it from its founders in 1989, wrote in his book *Pour Your Heart into It* that if you “treat people like family . . . they will be loyal and give their all.”<sup>80</sup> Customers were also important for Starbucks. The aim of the company to create enthusiastic, loyal customers was secured by offering a special ambience in its stores and a guarantee of the finest coffee available. The Starbucks mission statement expressed a firm commitment not only to treat employees and customers well but also to benefit communities and protect the environment. It was characteristic of the Starbucks philosophy that the mission statement mentioned the need for profitability last.

## Fair Trade Campaign

In 2000, Starbucks was confronted with a demand that the company buy fair trade coffee.<sup>81</sup> Global Exchange, a non-governmental organization (NGO) that focused on human rights, accused Starbucks of making a profit at the expense of coffee growers in poor countries, who received a small portion of the world price for their beans. The first salvo in the Global Exchange campaign took place in February with a demonstration at a San Francisco Starbucks store. A few days later, leaders from the NGO appeared at the annual meeting of Starbucks and threatened a national boycott if the company refused to buy and promote fair trade coffee.

The fair trade movement, which gained impetus in the 1990s, seeks fair compensation for the producers of basic commodities and mutual respect between producers and buyers. In 1999, the organization TransFair USA began offering a certification for fair trade coffee, and Global Exchange launched an education campaign to persuade consumers to buy coffee with the TransFair USA logo.<sup>82</sup> According to TransFair USA, “Fair Trade Certification empowers growers

and farmworkers to lift themselves out of poverty by investing in their farms and communities, protecting the environment, and developing the business skills necessary to compete in the global marketplace.” Products, including not only coffee but also tea, cocoa, rice, vanilla, honey, sugar, and flowers, qualify for fair trade certification if the six conditions described in Table 12.4 are met.

**Table 12.4** Requirements for Fair Trade Certification

How well do you understand the principles of “fair trade” and its objectives? Review the required conditions for a product to receive fair trade certification and the explanation of each. Hide the cells in the table to quiz yourself.

Condition	Description
<b>Fair prices</b>	Democratically organized farmer groups receive a guaranteed minimum floor price and an additional premium for certified organic products. Farmer organizations are also eligible for pre-harvest credit.
<b>Fair labor conditions</b>	Workers on Fair Trade farms enjoy freedom of association, safe working conditions, and living wages. Forced child labor is strictly prohibited.
<b>Direct trade</b>	Importers purchase from Fair Trade producer groups as directly as possible, eliminating unnecessary middlemen and empowering farmers to develop the business capacity necessary to compete in the global marketplace.
<b>Democratic and transparent organizations</b>	Fair Trade farmers and farmworkers decide democratically how to invest Fair Trade revenues.
<b>Community development</b>	Fair Trade farmers and farmworkers invest Fair Trade premiums in social and business development projects such as scholarship programs, quality-improvement training, and organic certification.
<b>Environmental sustainability</b>	Harmful agrochemicals and GMOs are strictly prohibited in favor of environmentally sustainable farming methods that protect farmers’ health and preserve valuable ecosystems for future generations.

The fair trade movement addresses several factors in global coffee trade that disadvantage small growers in developing countries.

### What challenges do these small coffee growers face?

**First**, the coffee market consists of a long supply chain with many intermediaries between the growers and the eventual consumers. In 2000, more than 50 percent of all coffee beans were grown on small plots of land. Individual growers and some small cooperatives lacked the machinery for the next stage of hulling the beans, leading them to sell their crop to the owners of local mills. From there, the raw beans passed through many layers of middlemen before they were roasted and offered for sale to consumers. As a result, growers received only a small portion of the world market price for finished beans.

**Second**, many growers had difficulty obtaining financing and so were forced to sell their anticipated crop to middlemen for a cash advance. Not only did this arrangement limit their bargaining power over price, but it also kept them mired in a continuous cycle of poverty.



**Third**, the prices of all agricultural commodities are subject to wide fluctuations based on supply and demand. High prices when supplies are short encourage overproduction, which leads to subsequent low prices; and when the resulting reduction in supply leads to higher prices, the cycle starts over again. By 2000, an oversupply of coffee beans had pushed prices down to the lowest levels in 50 years, and the world price for raw beans fell to 64 cents per pound. Although in 2000, Starbucks paid an average of \$1.24 per pound, which was almost double the lowest price, much of the difference was due to the company's purchase of premium beans.

## Starbucks Responds

The demand by Global Exchange for Starbucks to purchase and promote fair trade coffee fit with the principles in the company's mission statement, especially the commitment to apply high standards in the purchase of coffee beans. Some customers had requested not only fair trade coffee but also coffee grown in the shade to protect bird habitats and organic coffee grown without chemicals.<sup>83</sup> However, the customer demand for fair trade coffee was unknown. Partners (the Starbucks term for employees) might find more satisfaction in their work if the company were to offer fair trade coffee and might be distressed by a boycott against the company. Moreover, Starbucks had already worked with NGOs on several social and environmental projects. The company contributed to CARE, an international humanitarian organization devoted to fighting global poverty, with instructions that its funds be directed to coffee-growing countries. In 1998, Starbucks joined with Conservation International to promote shade-grown coffee, which brought many benefits to coffee cooperatives in Chiapas, Mexico. In 1994, Starbucks established a department of Environmental Affairs, and created a department of Corporate Social Responsibility in 1999.

Although the demand by Global Exchange fit with Starbucks' mission, company executives were concerned whether it was compatible with Starbucks' successful strategy of offering high-quality coffee at premium prices. The company's reputation was built on meeting customers' expectations of a certain experience. Sourcing fair trade coffee would mean dealing with suppliers whose record for consistent high quality, uniformity in taste, and reliability in delivery was unknown. The head of bean purchasing at Starbucks cautioned, "This was an uncharted category, and, as marketers, we were concerned about endorsing a product that didn't meet our quality standards." Although the price of free trade coffee was only 6 cents per pound more than Starbucks generally paid, additional costs would be incurred in identifying fair trade growers and working with them, if necessary, to meet Starbucks' high standards. Developing a marketing campaign would entail further costs.

Starbucks executives also needed to consider the impact of sourcing fair trade coffee on the company's relationships with its regular suppliers around the world who had managed to obtain the high price offered by Starbucks only by meeting the company's high standards. As one executive explained,

The relationships I have with growers were built over the last 20 years. It's taken some of them years before I would use their beans consistently and pay them \$1.25 or more. Now I was being asked to use another farmer who I didn't know and pay him the same price without the same quality standards.

Many of Starbucks' suppliers could not meet the criteria for fair trade certification because they were large growers and not individual farmers or cooperatives, and so they could not be run democratically as the fair trade criteria required.

Starbucks executives also faced the following questions.

### **How much of the higher price for fair trade coffee would actually reach the growers?**

Critics of the fair trade movement charge that too many fair trade dollars end up in the pockets of middlemen and NGOs.<sup>84</sup> TransFair USA claims that fair trade can eliminate as many as five layers of middlemen by enabling growers to deal directly with American wholesalers and thereby double or triple their income.<sup>85</sup> However, it is difficult for purchasers of fair trade coffee to know how much the growers actually benefit. TransFair USA and other organizations that certify fair trade products collect a fee for monitoring and licensing growers. In 2005, TransFair USA collected \$1.89 million in fees, spending most of this amount on salaries, travel, and other expenses for its 40 employees.<sup>86</sup> Fee income rose to \$7 million by 2009.<sup>87</sup>

Ensuring that fair trade products meet the criteria for certification involves some monitoring, and so the relevant question is whether this monitoring will be done by third parties, such as TransFair USA, or by the buyer, in this case Starbucks. In any event, monitoring imposes an extra cost that is borne ultimately by some party—either the grower in the form of a lower price for beans, the consumer in the form of higher prices for the brewed coffee, or by Starbucks shareholders in the form of lower earnings.

### **Is the fair trade movement an effective solution to the economic problems of coffee production by small growers in a world market?**

The fluctuation of supply and demand due to alternating overproduction and underproduction and the lack of credit that forces growers into a cycle of indebtedness are the inevitable result of too many coffee growers tilling small plots of land. Another solution besides the fair trade movement is to consolidate coffee bean production in larger farms with the capacity to switch to other agricultural products as the market changes. Such a transformation might force some growers off their land and reduce them to laborers for large

growers, or else it would send them to the cities in search of other employment.

The fair trade movement offers the prospect of improving the lives of one group of growers. However, unless demand for coffee beans increases—and worldwide per capita consumption of coffee has been declining since the 1960s—the main effect of the fair trade movement is that the coffee that is purchased by sellers, such as Starbucks, comes from the growers of fair trade coffee. As a result, the growers of non-fair trade coffee will sell less, and so the welfare of coffee growers worldwide will be unchanged.

### SHARED WRITING: STARBUCKS AND FAIR TRADE COFFEE

How much confidence do you have in the effectiveness of the fair trade certification system? Do you think buying fair trade coffee is a step in the right direction for Starbucks and other coffee retailers, even if the system is flawed? Explain.

▶ A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Timberland and Community Service

Our company is organized around values. Not out of convenience, but out of necessity.<sup>88</sup>

—Jeffrey Swartz, President and CEO,  
Timberland Company

Jeffrey Swartz, the President and CEO of Timberland Company, was the third-generation leader of a formerly family-owned business that went public in 1987.<sup>89</sup> In 1955, Swartz's grandfather, a Russian immigrant, bought the Abington Shoe Company, located in South Boston, Massachusetts, and brought his two sons into the business. The iconic Timberland boot was introduced in 1965 when the Swartz family developed a process for fusing rubber soles to leather uppers to form a rugged, waterproof boot that was also less expensive to produce. The success of the Timberland boot led the Swartz family to relocate in 1969 to Stratham, New Hampshire, and to change the name to Timberland Company in 1978. The growing company began to market a variety of casual and work footwear under the Timberland brand, and, later, introduced clothing and accessories for men, women, and children, as the company expanded sales to Europe, Asia, and Latin America. After graduation from

Brown University and the Amos Tuck School of Business at Dartmouth College, Jeffrey Swartz assumed a variety of positions at Timberland, becoming chief operating officer in 1991 at the age of 31 and president and CEO seven years later.

### “Commerce and Justice”

Under the leadership of Jeffrey Swartz, Timberland Company developed an expanding program of community service in an effort to combine “commerce and justice.” The centerpiece of this program was the trademarked Path of Service, launched in 1992, which allowed employees to devote 16 hours of company-paid time each year to community service. Path of Service was expanded to 32 hours in 1994, and to 40 hours in 1997. The purpose, as stated by Swartz, was “to engage the skills and talents of employees to create long-term solutions for critical community needs.” Although participation was optional, employees were encouraged to use the hours for their own favored causes or to participate in company-sponsored events. A new Community Enterprise Department was created to support the Path of Service program and other community service initiatives.

The origin of Timberland's commitment to community service was a chance encounter that Swartz made with the Boston-based nonprofit organization City Year. City Year was founded in 1988 to engage young people in a year of full-time service that gave them “the skills and opportunities to change the world.” After Timberland responded twice to requests for donations of boots, a founder of City Year called on Swartz to thank him and invited him and other Timberland employees to spend four hours of community service with a group of City Year volunteers. Swartz accepted the invitation and was appalled by the social problems he saw, as well as inspired by the possibilities for change. He reported of his experience:

And I found myself not a mile from our headquarters, face to face with the stories you read in the newspaper, face to face with a vision for America not unlike the one that drew my grandfather to leave Russia in steerage so many years ago. . . . Behind my desk again, safe no longer, moved by my own sense of purpose having served, albeit briefly, all that mattered was figuring out how service could become part of daily life at Timberland.<sup>90</sup>

Swartz gradually increased Timberland's support for City Year by making an initial pledge of \$1 million annually for three years, later extended for another five years, and loaning a Timberland executive to assist in marketing for City Year. Swartz became chairman of City Year's national board. In turn, City Year organized team-building exercises for Timberland employees, aided in creating community service projects, and, in 2000, located an office in Timberland's headquarters. Timberland expanded its community service program with two full days of activities,

one in the spring that coincided with Earth Day and another in the fall called Serv-a-palooza. The company extended its collaboration with nonprofit organizations by establishing links with Share Our Strength, an antipoverty group, and with Skills USA, which provided vocational training for young people.

## Testing the Commitment

If Timberland had remained a family-owned business, then Swartz could indulge his passion for service because he would be using his own resources. As a public company, however, he was responsible to shareholders. This responsibility was tested in the mid-1990s, when profits fell, and in 1995 the company suffered its first loss in net income. Although he was urged to cut the community service program, Swartz resisted. He believed that instead of being an expense that could be cut in bad times, the cost of community service was an investment of resources that contributed to the company's success. Community service, in his view, was a key part of the strategy at Timberland for fulfilling the company's mission and values, which in turn were integral to the company's main goals that included strong financial performance.

The mission of Timberland was stated in the company's 2006 CSR Report as "To equip people to make their difference in the world." Four core values were identified as guides for all company activity. These were humanity, humility, integrity, and excellence. And five "bold goals" were set forth:

- Become the authentic outdoor brand of choice by providing inventive and practical products to our consumers
- Be the business partner of choice by providing distinctive value to our customers
- Be a top employer of choice globally
- Be the reference for socially accountable business globally
- Deliver exceptional financial performance for shareholders

Swartz believed that these measures of the company's success—its mission, values, and goals—required not only the community service program but also ambitious initiatives to protect the environment and secure human rights in its manufacturing facilities worldwide.

Swartz expressed his belief in this connection of commerce and justice in the following way:

We operate on the core theory, on the belief that doing well and doing good are not separate ideas; they are inseparable ideas. That, in fact, they are inextricably linked and that everything we do, every business decision we make, every strategy we promulgate, every speech we make, or every pair of boots or shoes that we ship, have to

be the embodiment of commerce and justice, and that's a different model.

This is a model that had served Timberland well as it survived and even prospered in the highly competitive footwear industry. The questions remain, however, whether this is a model for many companies or industries, and whether it would remain a viable model for Timberland if its competitive environment changed or the company faced another economic downturn.

### Do you think Timberland's commitment to communities and social values was sustainable?

The economic situation did change for Timberland in 2011, when rising leather prices and higher labor costs combined to squeeze profits, which dropped 30 percent in the first quarter of the year.<sup>91</sup> A bid by clothing giant VF Corporation to buy Timberland for \$2.3 billion was quickly accepted by the board of directors and the shareholders, and Jeffrey Swartz gave up his leadership position and left the company his family founded and had managed for three generations. VF Corporation, which marketed Lee and Wrangler jeans, Nautica apparel, and North Face outerwear, kept the iconic Timberland brand but rolled operations into its Outdoor and Action Sports divisions. Swartz was apparently comfortable with the change, declaring "I am confident that while our ownership structure has changed, what makes Timberland unique and special will not."<sup>92</sup>

His confidence was borne out. A human relations executive for the Outdoor division said, "VF recognizes that service is a critical element of Timberland's culture," and announced that beginning in 2012, the two events of Earth Day and Serv-a-palooza would be observed by both the Outdoor and the Action Sports divisions. The VF executive explained, "We joined Timberland in service at last year's Serv-a-palooza and saw the benefits service brings to the work environment, the community, and to the business."<sup>93</sup> In April 2012, more than 4,500 VF employees observed Earth Day with service projects in 71 locations across the United States.

### SHARED WRITING: TIMBERLAND AND COMMUNITY SERVICE

Do you agree with Jeffrey Swartz's belief that "doing well and doing good are not separate ideas" but "inseparable ideas"? Do you share his confidence that Timberland's new owner, VF Corporation, will continue to uphold Schwartz's ideals and act on them? How could this continuity be assessed today? Explain.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: Coca-Cola's Water Use in India

On December 29, 2005, officials at the University of Michigan sent a letter informing The Coca-Cola Company that, effective January 1, 2006, all purchases of Coke products for on-campus sale in vending machines, cafeterias, restaurants, residence halls, and sport arenas would be suspended.<sup>94</sup> This suspension was the latest development in an ongoing campaign by student activists to support high standards of corporate conduct around the world through enforcement of a university Vendor Code of Conduct, which had been adopted in the spring of 2004 to address issues of human rights and environmental protection. Coca-Cola, whose contract with the university was worth \$1.4 million, became a target in this campaign after Amit Srivastava, the founder of India Resource Center, spoke on campus to raise student awareness about the depletion of groundwater around the plants producing Coke products.<sup>95</sup>

According to the *Wall Street Journal*, activists had accused Coca-Cola of “sucking local Indian communities dry through excessive pumping of groundwater.”<sup>96</sup> The greatest attention was focused on a plant in Kaladera, an impoverished community in the arid Indian state of Rajasthan, where water was supplied entirely by underground aquifers.<sup>97</sup> The local watershed, which covered about 120 square miles, had been officially declared “overexploited” in 1998. The groundwater level had dropped from 30 feet belowground to 128 feet over a period of 20 years, and since 1996, the rate of the drop had increased to 4.5 feet per year. This lowering of the groundwater level had forced farmers to drill ever deeper wells and install more powerful pumps, and the resulting difficulty of obtaining water limited crop output and the number of acres under cultivation.

The causes of this reduction in the water supply were disputed. Although Rajasthan receives little rainfall and suffers from periodic droughts, weather conditions had not worsened in recent years. However, urbanization, population growth, and higher incomes had increased the demand for water to the point where annual usage exceeded the natural recharge rate by 135 percent. In recent years, farmers, who used 91 percent of the water—the other nine percent went to household and industrial consumption—had drilled more wells, enlarged their fields, and shifted to more water-intensive crops. Because electricity was supplied at little or no cost and was subject to frequent outages, farmers often left their pumps running constantly, thereby wasting large quantities of water. Farmers had also resisted adoption of drip irrigation systems, which, although costly and difficult to maintain, reduce the amount of evaporation by releasing water directly into the soil.

When the Coca-Cola plant in Kaladera opened in 1999, it drew approximately 52.8 million gallons annually from the local aquifer, which was approximately 0.4 percent of the amount of underground water being consumed. Improvements in water efficiency—including a switch from refillable glass bottles to single-use plastic containers, which do not require washing but create landfill waste—eventually cut water use in half, so that in recent years, the Kaladera plant had accounted for only 0.2 percent of local water consumption. The impact of this relatively small usage on the water table was exacerbated, however, by heavy consumption in the summer months, which coincided with the period of least annual rainfall.

Although several other industrial facilities in the area, including a paper pulp plant, were also water-intensive producers, Coca-Cola was probably the largest single user of water. However, the fraction of 0.2 percent is minuscule in comparison to total water use, most of which occurred in agriculture. Agricultural use alone exceeded the natural recharge rate, so the water table would have been lowered to some extent regardless of household and industrial use. Moreover, Coca-Cola claimed, though proof was lacking, that the 140 rain water harvesting structures built by the company returned more than 15 times the amount of water to the aquifer than the Coke plant drew. However, many of these structures—which consisted of deep shafts dug in the ground—were found by a study to be in dilapidated condition, and their efficacy in returning rain water to the aquifer was also questioned.<sup>98</sup>

Critics of Coca-Cola's water use also considered how much water the company was “entitled” to use based on an equitable sharing of resources in proportion to the economic benefit of water use.

### **What do you think was determined to be Coca-Cola's “fair share” of the water?**

Although most of the water consumption occurred in agriculture, farmers constituted 15 percent of the local population (not counting family members who work on family farms), and the whole population depended critically on the food produced by local farms. By comparison, the highly mechanized Coca Cola plant employed between 70 and 250 people, depending on the season, who constituted a very small portion of the population. On the basis of employment alone, one observer calculated that the company's “fair share” of water use would be only 0.15 percent.<sup>99</sup> This figure would be further reduced by considering the importance of agriculture to the welfare of the people in comparison to other uses of water. The government had prioritized water use in the order: clean drinking water first, followed by agricultural use, power generation, and, finally, industrial production. In the category of industrial production, soft drinks are unlikely to be rated very highly by the Indian people.

The University of Michigan campus remained Coke-free for the first three months of 2006. During this time, Coca-Cola engaged in discussions with TERI (The Energy and Resources Institute), a highly respected research university in India devoted to environmental protection, to undertake an independent study of the impact of the company's operations.<sup>100</sup> On April 11, 2006, an agreement was reached in which the sale of Coca-Cola products was allowed to resume pending the findings of the TERI study, which would be released to the public without any interference by the company. Although the TERI report confirmed many basic facts about Coca-Cola's role in groundwater depletion and recommended some changes that were never implemented, the university was satisfied with the findings and, on October 13, 2008, a university official declared the student complaint "resolved to our satisfaction."<sup>101</sup> In 2011, the Coke's chairman and CEO, Muhtar Kent, affirmed, "At The Coca-Cola Company, we are transforming the way we think and act about water stewardship. It is in the long-

term interest of both our business and the communities where we operate to be good stewards of our most critical shared resource, water."<sup>102</sup>

### SHARED WRITING: COCA-COLA'S WATER USE IN INDIA

Are you satisfied with the resolution of this case? Do you think the University of Michigan should have insisted on the recommendations made by TERI in its report? Did Coca-Cola adequately handle the situation, or do you think it should have done more on its own? Explain.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

### Chapter 12 Quiz: Corporate Social Responsibility

## Chapter 13

# Governance, Accountability, and Compliance



## Learning Objectives

- 13.1** Identify the moral arguments and legal rules for shareholders' control of publicly held corporations, and the additional considerations for protecting the interests of other stakeholders
- 13.2** Critique how financial reporting, corporate management roles, and the law function to prevent fraud and other kinds of corporate misconduct, and how flaws in the system have allowed major scandals
- 13.3** Evaluate the components of corporate ethics programs, the federal guidelines designed to punish and prevent misconduct, and how adopting a code of ethics benefits companies

## Case: Fraud at WorldCom

When WorldCom filed for bankruptcy on July 22, 2002, its stock, which was once worth more than \$180 billion, became virtually worthless.<sup>1</sup> Although the company reported \$107 billion in assets, it had accumulated more than \$41 billion in debt in the course of a buying spree that had fueled its rapid growth. The downfall of WorldCom was sealed in late June, when the company revealed that more than \$3.8 billion had been improperly booked as revenue, a figure that eventually rose to \$11 billion. The revelation of improper accounting forced WorldCom to write down more than 75 percent of its reported assets. WorldCom set new world records for the largest company ever to go bankrupt, surpassing Enron, and for the largest accounting fraud.

### Creative Accounting

WorldCom started as a small long-distance carrier founded in Clinton, Mississippi, in 1984, by nine investors. One of the founders was Bernard J. (Bernie) Ebbers, who was a former milkman, bartender, high school basketball coach, and, at the time, owner of 13 budget hotels. After Mr. Ebbers was asked to take the helm of the struggling company, it began to expand through aggressive acquisitions. Between 1991 and 1997, 65 regional and national telephone companies were bought, culminating in 1997 with the purchase of MCI, then the nation's second-largest long-distance

carrier. In 1995, the emerging conglomerate assumed the name WorldCom. The acquisitions enabled WorldCom's stock to become a darling of Wall Street through creative accounting devised by the company's whiz-kid CFO, Scott Sullivan.

Mr. Sullivan utilized several accounting treatments that served to steadily increase WorldCom's earnings, along with its stock price.<sup>2</sup> In each acquisition, the value of the assets was reduced by charging future expenses against them. The result was lower earnings initially but a guarantee of higher earnings over time. The value of the assets was further reduced by transferring funds to "cookie-jar" reserves that could be tapped when needed to meet analysts' earnings expectations. In addition, some of the book value of the assets acquired was shifted from tangible or hard assets, which had to be charged against earnings over a short period, to intangible assets, such as brand name and good will, which could be amortized over longer periods of time. As a result, a smaller amount due to the acquisitions had to be charged against earnings as the company was growing. The overall effect of these accounting treatments was to give a picture of a growing company with a reliable, steadily rising income. This effect was critical for WorldCom's growth since acquisitions were financed with WorldCom stock, and the rising price of the stock enabled the company to make more acquisitions.

This rosy financial picture did not match the company's operations. Bernie Ebbers was known as a hands-off manager with little concern for the integration of the companies he

acquired. The employees and customers of the acquired companies remained segmented, and departments of the company, including the critical legal staff, were located in different cities. Each office had its own policies and managerial style. More importantly, the telephone routing equipment that handled calls and the customer and maintenance services were not combined into a seamless system. Complaints from disgruntled users flooded the company. The company culture that was developing encouraged “a systemic attitude conveyed from the top down that employees should not question their superiors, but simply do what they were told.”<sup>3</sup> In a report issued after WorldCom’s collapse, Mr. Ebbers was recalled as saying that the project to write a code of ethics was “a colossal waste of time,” and the writers of the report observed, “While we have heard numerous accounts of Ebbers’ demand for results—on occasion emotional, insulting, and with express reference to the personal financial harm he faced if the stock price declined—we have heard none in which he demanded or rewarded ethical business practices.”<sup>4</sup>

Despite its dysfunctional operations, WorldCom was able to continue its accounting-aided financial success as long as new acquisitions were found. This strategy by acquisitions came to a halt when the company’s ambitious bid to acquire Sprint was scuttled by the U.S. Department of Justice in July 2000. Suddenly the revenues needed to meet analysts’ expectations had to be found elsewhere. It was reported that at this point, “Ebbers appeared to lack a strategic sense of direction, and the Company began drifting.”<sup>5</sup> Scott Sullivan had a plan, though. In October 2000, he ordered the controller David F. Myers and the accounting director Buford Yates, Jr., to divert funds that had been set aside, as required by accounting rules, to pay for line expenses. WorldCom’s telephone system required the lease of telephone lines from other companies to complete calls, and the cost of these leases constituted a major expense, approximately 42 percent of total revenues. Because the revenues to pay for line expenses were collected several months before the payments were due, generally accepted accounting principles (GAAP) required that funds be set aside as an accounting accrual so that the receipts and expenditures matched. If the cost of the line leases was less than the amount set aside, the difference could be added to revenue as an accrual release, but not before the expenses were paid.

## How did WorldCom’s scheme unravel?

### The Scheme Unravels

The task of making the accounting entry that would release the accruals fell to Betty Vinson, a diligent, hardworking, loyal employee, who, it was said by a colleague, would “do anything you told her to do.”<sup>6</sup> Ms. Vinson said that she was “shocked” when she was told to transfer \$828 million from the reserved accruals to current revenues, and she expressed her view that the accounting entry was improper.<sup>7</sup> She made the entry reluctantly, and on October 26, 2000, she and another colleague

announced their plans to resign. When he heard this news, Mr. Ebbers assured Mr. Myers that the accountants would never be asked to do this again. Scott Sullivan also attempted to placate the distraught accountants. He is reported to have said, “Think of it as an aircraft carrier. We have planes in the air. Let’s get the planes landed. Once they are landed, if you still want to leave, then leave. But not while planes are in the air.”<sup>8</sup> Mr. Sullivan assured them that the transfer was not illegal and that he would assume full responsibility. The two accountants agreed to stay.

At the end of the first quarter of 2001, it became evident that WorldCom would not meet its expected earnings target without a boost from accounting. Increased competition in the telephone industry, overcapacity of telephone lines, and a decreased demand for telephone services combined to reduce the revenues of all companies. This time, there were not enough accruals for line leases left to cover the expected shortfall, and so Mr. Sullivan developed another plan. Ms. Vinson was ordered to record \$771 million of line expenses as capital investment. In its bid to grow, WorldCom had entered into expensive long-term leases of telephone lines that were being underutilized, and the excess expense was a drain on the company’s bottom line. Mr. Sullivan’s rationale for recording a portion of the line lease payments as capital investment was that the unused capacity was a resource that would enable the company to grow. On the books, a capital investment shows up as an asset rather than as an expense, and its cost can be spread over a longer period of time.

Although Ms. Vinson put together a résumé and began looking for another job, she made the accounting entry, back-dating it to February. For the remainder of 2001, she was asked to repeat the accounting procedure, improperly recording \$560 million in the second quarter, \$743 million in the third quarter, and \$941 million in the fourth, each time hoping the entry would be the last.<sup>9</sup> After realizing that the transfers would have to continue through 2002 if WorldCom were to meet analysts’ expectations, Ms. Vinson and another colleague announced to Mr. Myers that they would no longer make these improper entries into the company’s books.

Further entries proved unnecessary. In March, investigators from the Securities and Exchange Commission (SEC) began asking for documents, and Cynthia Cooper, WorldCom’s head of internal audit, also initiated inquiries. Betty Vinson and Buford Yates hired an attorney and agreed to talk with federal investigators in the hopes of avoiding indictments. On April 26, 2002, Mr. Ebbers was dismissed by the board of directors for a lack of strategic vision and also because of difficulties from his outside business interests and his inability to repay loans made by the company. On June 20, Ms. Cooper and her internal audit staff presented their findings to the board of directors, which demanded the resignations of Sullivan and Yates. On June 26, the SEC brought civil charges of fraud against WorldCom and began criminal proceedings against Bernie Ebbers, Scott Sullivan, David

Myers, Buford Yates, and Betty Vinson. All were found guilty. Ebbers was sentenced to 25 years in prison, and Sullivan, to 5. Myers and Yates each got one year, and Betty Vinson received a sentence of five months in prison and five months of home

detention. Although Ms. Vinson played a small role and was put into a difficult situation by her superiors, the U.S. attorney who prosecuted the case said that “just following orders” is not an excuse for breaking the law.<sup>10</sup>

## Points to Consider . . .

A corporation brings together many different groups—most notably managers, employees, suppliers, customers, and, of course, investors—for the purpose of conducting business. Because these various corporate constituencies have different and sometimes conflicting interests, many problems arise, which must be resolved if business is to be conducted successfully. Ideally, these groups should cooperate harmoniously for maximum productivity and mutual benefit.

**One critical problem in conducting business in the modern corporation is determining what group or groups should have major decision-making power or control.** This matter is the subject of corporate governance, and in the standard model of corporate governance, control is held by the shareholders in accord with a doctrine known as *shareholder primacy*. Because they have the legal right of control, shareholders are able to set the objective of a corporation, which is generally regarded as maximizing profits, and since profits accrue to shareholders, the objective of a business corporation is commonly expressed as shareholder wealth maximization (SWM). One task of this chapter, then, is to understand the justification of shareholder primacy and the resultant objective of SWM.

Even if corporations are controlled by shareholders, conducting business is still a cooperative venture with contributions from many groups. The common cliché in business, “Employees are our most important asset,” attests to the importance of this essential group. And Peter Drucker took issue with the focus on shareholders when he declared, “There is only one valid definition of business purpose: *to create a customer.*”<sup>11</sup> Not only employees and customers but suppliers and non-shareholder investors, such as bank lenders and bondholders, must be induced to contribute to the productive activity that creates the shareholders’ profits. These groups, along with shareholders or stockholders, are commonly identified as *stakeholders*, and because of their importance for success in business, the interest of these groups must be considered in corporate decision making. A complete justification of shareholder primacy necessarily involves an understanding of the proper role of all stakeholders, and not just shareholders, in corporate governance.

**In addition to these problems involving decision-making power or corporate control, a corporation also needs a control environment to ensure that employees do their job well and do not engage in unethical and/or**

**illegal behavior.** To ensure that shareholders and, indeed, all stakeholders are protected from corporate malfeasance, controls must be in place to ensure corporate accountability. In particular, the prominent examples of fraud perpetrated by high-level executives at Enron, WorldCom, Adelphia, and Parmalat, to name just a few, show the need not only for better corporate governance but also for tighter control systems. These systems include financial reporting requirements, effective oversight by boards of directors and company executives, and, in extreme cases, use of the criminal law. A control environment consists not only of rules and policies for employees’ behavior but also securing compliance by educating employees about proper conduct and responding to possible misconduct. For this purpose, most corporations have established corporate ethics programs. Both corporate accountability systems and corporate ethics or compliance programs are considered in this chapter.

## 13.1: Corporate Governance

### 13.1 Identify the moral arguments and legal rules for shareholders’ control of publicly held corporations, and the additional considerations for protecting the interests of other stakeholders

In its broadest sense, corporate governance includes all the factors that determine how decisions are made in business organizations that are organized as corporations. The shareholders of publicly held corporations and the directors, whom shareholders elect, are commonly recognized as having *de jure* or legal control, but these shareholders and directors, as well as the managers, who typically exercise *de facto* control or control in fact of day-to-day business operations, are subject to the power of many groups that, acting within their legal rights, strongly influence, and often determine, corporate decisions.

Most notable among these groups that affect corporate decisions are

- governments at all levels, which have the legal power to regulate and tax;
- auditors and accounting standard setters;
- securities exchanges, which set many rules for listed companies;
- rating agencies, which rate a company’s securities;



- banks, which provide loans and exercise close monitoring;
- the media, which inform the public of a company's activities; and
- all the markets in which corporations operate—capital markets, labor markets, commodity markets, and consumer markets.

In addition, many decisions in business firms are made by employees at all levels as part of their role responsibilities. These diverse groups provide a multitude of forces that bear on corporate decision making.

Viewed in this broad sense, corporate decision making is very highly dispersed among many groups, and the most recognized corporate governance actors—namely shareholders, directors, and senior executives—make comparatively few decisions. However, these decisions are among the most important ones for the operation of a company, and it is these major decisions that are identified with questions about the ultimate *de jure* control of business organizations that are answered by corporate governance. Corporate governance in this more common, narrower sense of the term is the set of legal rules that confer rights to make the most important decisions that constitute corporate control, as well as the legal rules that specify the processes and procedures by which this decision-making power or control is exercised.

However, the assignment of control rights, as well as the processes and procedures for exercising these rights, is of little importance in a corporation that is owned and managed by a single individual or a small group—which is to say a corporation without a separation of ownership and *de facto* control. The legal rules that comprise corporate governance become critical mainly when there are a large number of diverse shareholders and a separation of ownership and *de facto* control. Under such conditions, conflicts over control arise among the different parties, and legal rules become necessary to protect the rights and interests of each group and ensure that decisions serve the proper corporate objective.

### 13.1.1: Shareholder Control

In a capitalist economy, most large business organizations or firms are legally structured as publicly held for-profit corporations, in which shares are bought and sold by the public in a stock market. In privately held corporations, by contrast, shares are owned by the founders or else traded in private transactions. Start-up companies are typically held privately by the founders, who eventually sell the company to investors in an initial public offering (IPO). By selling the company in an IPO, founders are able to “cash out” and realize the value of the firm they have created. Businesses may also be organized as sole proprietorships, partnerships, cooperatives, and the like, and many

organizations are not-for-profit. Although these other forms of organization are subject to governance rules, they do not commonly involve the significant conflicts over control that characterize publicly held corporations, and, consequently, they raise fewer concerns about their governance.

**JUSTIFYING CONTROL** Shareholders' control of publicly held corporations means that they have the right to make the major decisions about their operations, including the objective or ultimate goal to be sought. For-profit corporations are commonly said to have the single objective of maximizing profits and, in so doing, maximizing shareholder value or shareholder wealth, which is the result of maximizing profits since shareholders are the recipients of a firm's profits. It is important to understand, however, that the objective of shareholder wealth maximization is not inherent in the for-profit corporate form but arises from the exercise of the shareholders' right of control. Using this right of control, shareholders typically make the maximization of shareholder wealth the objective of the firm, but this objective is a choice made by shareholders and is not a legal requirement.<sup>12</sup>

Given the importance of control in the operations of corporations, the main moral question about corporate governance is why shareholders, morally, ought to have this right of control and why, morally, their interests ought to be the objective of the firm. This right of control with its corresponding role for shareholders in a firm's objective is often expressed as the doctrine of *shareholder primacy*. So the main moral question about corporate governance is the justification of shareholder primacy.

How are shareholders justified in having exclusive legal control of publicly held corporations?

The answers to further questions about the processes and procedures of corporate governance—for example, the specific rights of shareholders in exercising control and the fiduciary duty of officers and directors—follow largely from the justification of the shareholder primacy doctrine.

In addition to the right to control, shareholders possess another defining right, namely, a claim on the residual revenues or profits of a corporation. Many groups have a claim on a corporation's revenues. These include bondholders, who have claims for interest and principal payments; employees, who have claims on revenues for payment of wages; suppliers, who have claims for the payment of materials; government, which has a claim for payment of fees and taxes; and so on. Most of the income that a corporation generates from customers and other sources is paid out to a variety of groups that have fixed claims on a firm's revenue. *Fixed claims* are debts that a corporation is legally obligated to satisfy as long as the firm is solvent. A firm that cannot satisfy all fixed claims or debts is, by definition, insolvent. Whatever income remains after all fixed

claims are satisfied—that is, all bills are paid—constitutes residual revenue, and the shareholders' right to residual revenues constitutes *residual claims*.

Every claim on a corporation's revenues is a return for some resource that is contributed for production. Employees contribute labor, suppliers contribute materials, and bank lenders and bondholders contribute debt capital. (Customers do not contribute to production, but they provide the necessary element of revenue when they purchase product.) So shareholders, who typically finance a corporation with equity capital—as opposed to the debt capital provided by bank lenders and bondholders—contribute a necessary and distinctive resource, and they accept, in return, the residual revenues or profits of the firm.

Shareholders may be defined, then, as *the group that has both the right of control and a claim on profits*.

The justification of the shareholders' right of control, or shareholder primacy, has two sources, which reach the same conclusion by different routes.

- One source is *public policy*, which asks, in this case, what form of governance best serves the well-being of society.
- The other source is the *market*, which reveals the form of governance that would result from voluntary market transactions.

More specifically, corporations must contract in a market with shareholders for the provision of equity capital. The question then becomes: What terms would corporations and investors find mutually agreeable, consistent with all the other contracts that a corporation must form? Any system of corporate governance that emerges from the market for equity capital is a reflection of how shareholders' property rights are exercised and protected.

### What is the significance of these two sources of support for shareholder primacy?

Public policy's support of shareholder primacy reflects the fact that much of corporate governance is established in law by government through legislation, regulation, and adjudication, and public policy is a major factor guiding these processes. Public policy is also reflected in public attitudes toward business generally and in each company's reputation. In creating the body of law for corporate governance, one of government's main concerns is to ensure that business organizations serve the public good. Shareholder primacy conduces to the public good mainly by providing the legal protection necessary for investors to fund business ventures.

Government action may also aim to protect property rights, thus leading to the market as the second source of justification for shareholder primacy. Insofar as corporations result from private contracting among individuals in the exercise of their property rights, then the contracting that forms a

corporation may include the assignment of decision-making rights. In this way, the rules of corporate governance result from individuals' market transactions. Corporate law, especially in Anglo-American countries, permits business firms great latitude in choosing the terms of their legal incorporation. In the United States, where corporate law is a function of states, not the federal government, firms may choose to incorporate in the state with the most advantageous system. Furthermore, much corporate law is *default* legislation that applies unless incorporators contract differently, and so the amount of *mandatory* legislation that must be observed is relatively small. (A third division is *enabling* legislation, which provides rules for accomplishing certain tasks, such as forming a corporation.) Consequently, at least in Anglo-American countries, the market is a major factor, along with public policy, in explaining why shareholder primacy is central to corporate governance.

## WRITING PROMPT

### The Shareholder Primacy Doctrine

What is your opinion of the doctrine of shareholder primacy? Consider the justifications for the doctrine—the public policy and market arguments—as described thus far. Summarize one argument and explain whether you find it persuasive.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

**PUBLIC POLICY** Traditionally, the law on corporate governance has been guided by two conceptions of the corporation: one conception as the private property of the owners of the enterprise and the other as a right granted or conceded by the state. However, the idea that shareholders are the owners of the modern publicly held corporation whose claims are based on property rights ended with the separation of ownership and control that was observed by Adolf A. Berle, Jr., and Gardiner C. Means in their famous 1932 book *The Modern Corporation and Private Property*.<sup>13</sup> There they argued that shareholders had forfeited any claim to control based on ownership because, with the separation of ownership and control, they had ceased to exercise the responsibility traditionally associated with having ownership.

Traditionally, control is a feature of property ownership, but ownership with control over a thing involves an assumption of responsibility for the use of that thing. With the separation of ownership and control, shareholders relinquish *de facto* day-to-day control to professional managers and, at the same time, relieve themselves of any legal responsibility for corporate actions. As a result, shareholders of large, publicly held corporations cease to be owners in the full sense and become merely a provider of one kind

of resource needed by a corporation, namely, equity capital. According to Berle and Means, “The property owner who invests in a modern corporation so far surrenders his wealth to those in control of the corporation that he has exchanged the position of independent owner for one in which he may become merely recipient of the wages of capital.”<sup>14</sup>

Without property rights as a basis for shareholder primacy, what else could justify the claim that shareholders ought to have control of a corporation?

Berle’s answer to this question was that without strong shareholder control, corporate management would be effectively unconstrained and that such power would be dangerous to the economic order.<sup>15</sup> It would be unwise, in Berle’s judgment, for the law to release managers from a strict accountability to shareholders, not out of respect for their property rights (for they have none) but as a matter of sound public policy. In short, shareholder primacy is justified, in Berle’s view, for its efficacy in constraining and guiding management, which is in the public’s interest. However, a more powerful public policy justification for the shareholders’ role in corporate governance can be constructed by determining which group can operate a firm most efficiently for maximum value or wealth creation.

Efficiency is both an economic and a moral value because operating a business organization efficiently—which means producing the greatest amount of output for the least input—creates greater prosperity or material well-being than operating inefficiently. Other things being equal, we should prefer more rather than fewer material goods from any given resources, and corporations ought to be governed so as to achieve this end. Therefore, if one group can exercise ultimate decision-making power with greater efficiency and wealth creation than any other group, then, on the basis of public policy, that group ought to have control. Although this group may receive some benefit from having control, its members also provide a service that makes everyone in society better off.

**INCENTIVES** This public policy justification of shareholder primacy is completed by arguing that, under most conditions, the financiers of a corporation—which is to say the investors of equity capital who receive the profits—have the strongest incentives to achieve the greatest efficiency and hence to create the greatest amount of value or wealth, which benefits the whole of society. Under some conditions the greatest efficiency and wealth can be obtained from control by employees or by customers or suppliers, and, as a result, some corporations are employee-owned, customer-owned, or supplier-owned. (These latter are called cooperatives, and Henry Hansmann has suggested that the shareholder-owned firm can be viewed as a “capital cooperative.”<sup>16</sup>) However, corporations are most commonly controlled by financiers or investors, and justifiably so due to their narrow focus on profits.

The main reason for this greater efficiency and wealth-creating power stems from the shareholders’ role as residual risk bearers. Given that the shareholders’ return on their contribution to production, namely equity capital, is a claim on residual revenues or profits, only they have an incentive that a firm be maximally profitable as opposed to merely solvent. Any group with fixed claims, such as employees, customers, or suppliers, has an interest only in a firm being solvent and thus able to satisfy this group’s fixed claims.

Groups with less incentive for risk:

- If employees, for instance, had control with only fixed claims for wages, they would tend to operate the firm with a low level of risk so as to assure their wages, even though greater risk might lead to greater wealth creation. Because the greater wealth creation would accrue disproportionately to other groups, especially shareholders in the form of profits, employees would be disinclined to take risks that might be socially desirable.
- Similarly, bondholders would prefer that a firm be operated at a low level of risk to avoid jeopardizing their fixed claims for principal and interest payments, since they, like employees, would derive little benefit from maximal wealth creation.
- Executives, too, would be sub-optimally risk averse unless they were given incentives tied to profits, which is the rationale for compensating executives with performance-based bonuses and stock options.

Even if these other groups owned the corporation and thus received the profits, their incentives to achieve maximum profitability might conflict with their other interests as employees, customers, bondholders, and so on. Furthermore, if more than one group owned a corporation, conflict among these groups, each with different interests, might impede efficient decision making.

From the point of view of public policy, decisions in a business organization ought to be made by the party or group with two features:

- the greatest amount of relevant knowledge and
- the strongest incentives to operate the firm for maximum efficiency and, consequently, maximum wealth creation.

Although shareholders lack much of the knowledge necessary to operate a firm and, consequently, must rely on board directors to exercise general oversight and managers to exercise day-to-day control, they alone have the right incentives to operate a firm for maximum wealth creation.

Moreover, the decisions that shareholders make about selecting a board of directors and approving major structural changes, such as mergers and acquisitions, are matters about which shareholders are or can become knowledgeable. Perhaps the most important decisions that shareholders make are to buy and sell stock, thereby setting

prices for a company's shares that constitute an up-to-the-minute evaluation of a company's performance and prospects. In practice, shareholders make very few decisions, but their central role in corporate governance derives from the knowledge and, more importantly, the incentives they have in making some of the most critical decisions in the operation of a corporation.

**THE MARKET** In their role as financiers or investors, shareholders provide a critical resource needed by a business organization, namely capital. In return, they receive a payment or claim on revenues, specifically the residual revenues or profits of the firm. In this respect, shareholders are little different from other input providers, which include bank lenders, bondholders, employees, suppliers, and so on: They provide some resource and receive a payment in return. All these groups contract with a firm, and so the firm itself may be viewed as a nexus of all the contracts thus formed. To the extent that the return for the provision of any input is insecure, a contract is necessary to safeguard the return. On this nexus-of-contracts view, a firm "buys" capital in the same way it buys labor or materials, and such a purchase is an economic transaction that takes place in a market, namely a capital market, in the same way that a firm buys labor in a labor market and materials in commodities markets.

Corporate governance may be understood as the contract that a firm forms with its shareholders, who finance the firm by providing equity capital. And the terms of this contract are determined mainly in a market through a process of negotiation by firms seeking capital and by investors seeking to deploy their savings, with each party bargaining to obtain the best deal for itself. From a moral point of view, any agreement or contract that is formed by mutual consent between firms and investors is justified in the same way that the outcome of any market exchange is justified. The crucial task in justifying the role of shareholders in corporate governance is to understand why shareholder primacy would result from contracting between a firm and its financiers or investors. In particular,

Why would investors providing equity capital insist on obtaining control, in addition to residual revenues or profits?

Alternatively, why would a firm seeking capital offer control rights in addition to a claim on residual revenues?

The answer to both of these questions lies in the role of shareholders as *residual risk bearer*. Equity capital is different from debt capital, which is obtained in loans from banks or in bonds sold to bondholders.

- First, equity capital is provided for the life of a firm with no provision for its return, unlike the fixed term of a loan or a bond, during which time the whole principal must be repaid with interest.

- Second, equity capital has no fixed return, such as the specified interest on a loan or bond; the return is, rather, the profits of a firm, which are variable and may even be negative. By accepting a return in the form of a claim on residual revenues, shareholders become residual risk bearers. That is, they bear the risk of not obtaining an expected return because of the variability of residual revenues, including the possibility that a firm may fail completely.

Being a residual risk bearer is not only a benefit—a claim on the profits of a firm—but also a service that protects the fixed claims of other groups. Because shareholders do not need to be paid if there are no residual revenues, a firm can suffer a loss without becoming insolvent and being forced into bankruptcy and possible liquidation. By serving as residual risk bearers, shareholders thus make the fixed claims of other groups more secure. Shareholders are compensated for this service by the prospect of higher returns when a firm is exceptionally profitable.

The market justification for shareholder primacy holds that a firm contracts with investors in a market in order to obtain a necessary input, namely equity capital. In addition, investors provide the firm with risk-bearing services, which are costly for investors and a benefit for all other groups. Like other providers of needed inputs, equity capital providers receive a return, which, for them, is the net revenues or profits of the firm. This market justification of shareholder primacy is not yet complete, however, for shareholder–investors also receive something else, in addition to profits: They, and they alone, receive certain control rights. Along with the profits of a firm, they also "buy" some measure of corporate control. In order to complete this market justification and understand why the right to profits and control rights go together, it is necessary to examine a problem with the contract that a firm forms with its equity capital providers.

### 13.1.2: The Shareholders' Contract

The role of residual risk bearer creates special contracting problems for shareholders. The fixed claims of other groups—employees for wages, for example, or suppliers for payments—are relatively easy to assure in legally enforceable contracts. By contrast, the profitability of a firm, upon which the return to shareholders depends, cannot be mandated in a contract. In a firm without a separation of ownership and control—that is, in a firm in which shareholders operate the business—there is no problem protecting the shareholders' return since they control the operation. Profitability is in their hands. However, once shareholders leave the task of operating a firm to professional managers and hence separate ownership and control, a problem arises as to how shareholders can be assured that these managers will operate the firm for maximum profitability.

### What is the solution to this problem?

The solution to this problem is for shareholders to accept the role of residual risk bearer only on the condition that they also have control. The roles of residual risk bearer and holder of control rights are conceptually distinct. In theory, different groups could hold these roles, and sometimes they do. In practice, however, few investors would be willing to become residual risk bearers without obtaining control. Without control rights, investors would generally insist on significantly higher returns to compensate for the greater risk, with the result that the cost of capital for firms would be much higher. Alternatively, firms can lower their capital costs by offering control rights as well as claims on profits when they seek capital from investors. Thus, control rights can be viewed not only as a demand by investors to secure the return on their contribution of capital but also as an offer from firms to obtain investors' capital on favorable terms.

Combining risk bearing and the right to control in the shareholders' role is not a complete solution to the contracting problem, however. Shareholders cannot merely order managers to operate a firm for maximum profit, because what managers need to do to make a firm maximally profitable is complex and uncertain. The best shareholders can do is ask managers to exert their best effort to be profitable. This is commonly done not only by aligning managers' interests with those of shareholders by means of bonuses and stock options, but also by imposing a fiduciary duty on managers to act in all matters in the shareholders' interests.

The fiduciary duty of directors and officers is a major feature of the law of corporate governance, which is designed to overcome the fact that shareholders cannot bind persons by explicit contracts that fully specify the conduct to be performed. That the fiduciary duty of management flows mainly to shareholders is often thought to privilege shareholders in some way, but it should be understood that making shareholders the sole beneficiary of managers' fiduciary duty is a solution to the distinctive contracting problem that equity investors have with a firm. This solution reflects the vulnerability of shareholders and the relative invulnerability of all other groups, which, in any event, are better protected by, and thus prefer, other contractual means for securing their due return.

This account provides a partial explanation of why residual risk bearers would seek control, as well as the benefit of managers' fiduciary duty, namely to protect their at-risk return for providing equity capital. Although assuming residual risk and the right of control have costs for shareholders, the benefit to them for incurring these costs is greater than the benefits for any other group with only fixed claims, since these other groups can protect their claims more effectively and economically by other

contracting means. In short, control is worth more to residual risk bearers than any other group, and so they are willing to pay more for it.

In addition, shareholders are able to bear the costs of residual risk bearing more economically than other groups, which further reduces the cost overall.

- First, shareholders as equity capital providers are better able than employees, customers, suppliers, or other groups to diversify their investments in a firm. One reason why employee-owned firms, for example, are relatively rare is that an employee's whole wealth becomes tied up in the company, thus increasing that person's overall level of risk.
- Second, an active market for corporate control assures that if any group can operate a firm at lower cost or with greater efficiency or wealth creation than the current shareholders, they will do so. As with any good in a market, corporate control will be obtained through more efficient transactions by the party to whom it is worth the most, which will be the party that can operate a corporation for maximal wealth creation.

To summarize, corporate governance is the contract between shareholders and a firm that confers control rights on the shareholders, along with the benefit of managers' fiduciary duty, in order to protect the shareholders' claim to residual revenues or profits. Unlike the contracts that other groups enter into with a firm, this contract is unusually complex due to special contracting problems in the relationship between shareholders and the firm. Although the terms of this contract are, to some extent, specified by law, corporations still have great flexibility to negotiate with investors in a market, and the law itself largely reflects the terms that would result from market negotiations. Thus, the tendency of corporate governance laws to recognize the primacy of shareholders is determined by both public policy and the market and is justified on both grounds. That is, shareholder primacy serves to promote the welfare of society and is the result of voluntary, efficiency-promoting market transactions.

### WRITING PROMPT

#### Balancing Control, Risk, and Benefits

How does the idea of a contract between a corporation and its shareholders help to explain why the objective of managers and directors is ultimately shareholder wealth? How might it also help to explain why some companies are privately owned and managed rather than being public companies? What are the advantages and disadvantages of being privately or publicly owned?



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### 13.1.3: Shareholders and Stakeholders

Corporate governance, with its doctrine of shareholder primacy and the objective of shareholder wealth maximization, appears to privilege shareholders and elevate their interests above those of other groups, most notably employees, customers, suppliers, and non-shareholder investors, as well as community members. These groups, along with shareholders or stockholders, are commonly identified as *stakeholders*. Sample definitions of a stakeholder are “those groups who are vital to the survival and success of the corporation”<sup>17</sup> and “any group or individual who can affect or is affected by the achievement of the organization’s objectives.”<sup>18</sup> The concept of a stakeholder highlights the fact that a corporation interacts continually with its stakeholder groups and that much of the success of any business organization depends on how well all of these stakeholder relationships are managed.

The *concept* of a stakeholder is of undeniable importance: Corporations have stakeholders, and their effective management is essential for achieving corporate success. More problematic is the use to be made of this concept.

How should managers of a firm think about stakeholders? In particular, how does the important task of managing stakeholder relationships fit with the doctrine of shareholder primacy and the objective of shareholder wealth maximization?

No less a corporate titan than Jack Welch, the former CEO of General Electric, who was hailed by *Financial Times* as the “the father of the ‘shareholder value’ movement,” declared, “On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy. . . . Your main constituencies are your employees, your customers and your products.”<sup>19</sup> For Welch, there is no necessary conflict between shareholder value and stakeholder focus: The latter is essential for achieving the former.

**STAKEHOLDER THEORY** The concept of stakeholders has been developed in recent thinking about firms into a theory, called *stakeholder theory*. Thomas Donaldson and Lee E. Preston distinguish three uses of stakeholder theory: *descriptive*, *instrumental*, and *normative*.<sup>20</sup>

**First, the theory can be used as a *description* of the corporation that enables us to understand the corporation better.** Thus, a researcher who believes that the stakeholder theory accurately describes corporations can use it to answer questions about how corporations are organized and managed. The claim that stakeholder theory provides an accurate description can be confirmed to the extent that the answers to these research questions are put to a test and empirically verified.

**Second, the stakeholder theory can be used *instrumentally* as a tool for managers.** Even if making a profit

for shareholders is the ultimate goal of corporate activity, this point does not provide much help in the daily conduct of business. By contrast, telling managers to handle stakeholder relationships well is a more practical action guide that may actually lead to greater profit. In addition, companies faced with social and political challenges may find that relationships with stakeholder groups are valuable resources. James E. Post, Lee E. Preston, and Sybille Sachs argue that in recent years, corporations have been forced by social and political challenges in their competitive environments to become “extended enterprises,” in which relationships with stakeholders become not only necessary for survival but also a source of organizational wealth.<sup>21</sup> They write, “The long-term survival and success of a firm is determined by its ability to establish and maintain relationships within its entire network of stakeholders.”<sup>22</sup>

**Third, the stakeholder theory can be used as a *normative* account of how corporations ought to treat their various stakeholder groups.** Normative stakeholder theory would have managers recognize the interests of employees, customers, and others as worth furthering for their own sakes. As Donaldson and Preston explain, “The interests of all stakeholders are of ‘intrinsic value.’”<sup>23</sup> The central claim of a normative stakeholder theory is that corporations ought to be operated for the benefit of all those who have a *stake* in the enterprise, including employees, customers, suppliers, and the local community. It is only this third, normative use of stakeholder theory that might be incompatible with the standard model of corporate governance with its core features of shareholder primacy and shareholder wealth maximization. Some stakeholder theorists argue that shareholder control of corporations unjustly neglects the interests of other corporate constituencies. Instead of serving only the interests of shareholders alone, they argue that corporations ought to be run in the interests of all stakeholder groups.<sup>24</sup>

**PROTECTING STAKEHOLDERS** As a normative account of corporate governance, stakeholder theory is sometimes presented as an alternative to the standard shareholder- or stockholder-centered model, and a contrast is made between the stockholder and stakeholder theories of corporate governance as incompatible systems. If this is done, the two theories agree on at least one point: The purpose of the firm is to enable each corporate constituency or stakeholder group to obtain the maximum benefit from its involvement in the productive activities of a business organization. By providing inputs or resources to a firm, each group contributes to the creation of wealth, and this wealth is then distributed among all participants. One point of disagreement between the two theories concerns how best to secure each group’s return from the benefit of joint production in a firm.

What are the best means to ensure that each group receives its rightful return?

This question—how best to protect each stakeholder’s interest—is largely a pragmatic one about the effectiveness of the available means. What protections work best in practice? One way to answer this question is by conducting a thought experiment.

Suppose that the stakeholder theory were adopted by all firms in an economy. In such a system of corporate governance, all groups would share control of a firm, managers would have a fiduciary duty to act in the interests of all groups, and the objective of the firm would be to maximize the return of every group. The resulting economy would exemplify stakeholder theory. Now, add one more condition: that each group is free to opt out of a stakeholder system of governance and choose other means for protecting its interests. That is, they would have the opportunity to forgo the protection of management acting in their interests and seek contracts with a firm or different legal rules for protecting their interests.

Although opinions may differ on the system of corporate governance that might emerge from this thought experiment, there are good reasons to believe that each group would prefer the shareholder model.

**First, management decision making is a weaker form of protection than legally enforceable contracts or legal rules.** When such contracts and rules are available, they are more likely to be preferred than a reliance on management’s discretion. Shareholders are forced to rely on the protection of a fiduciary duty imposed on management because of problems that prevent them from utilizing fully specified contracts or precise legal rules. Fiduciary duty should be viewed, accordingly, not as a special privilege that shareholders enjoy but as an imperfect substitute when more effective means for protecting a group’s interests are not available.<sup>25</sup>

**Second, corporate decision making is more efficient and effective when management has a single, clearly defined objective.** The objective of maximum profits or shareholder wealth provides not only a workable decision guide but also one that increases the total wealth creation of the firm.<sup>26</sup> In turn, pursuing this singular objective of total value creation enables each group to obtain a greater return. That is, each group can get a larger piece of pie if the pie itself is larger. Thus, employees who seek greater job security or expanded benefits—which advocates of the stakeholder view would support—are more likely to get these goods if the employing company is prospering. A similar argument can be developed for customers, suppliers, investors, and every other stakeholder group. The benefits of a single objective would be compromised if other groups sought, like shareholders, to protect themselves with claims on management’s loyalty.

In this thought experiment, if each group would prefer to opt out of a system that relies on managerial discretion and to seek the protection of contracts and legal rules, the superiority of the shareholder theory over the stakeholder theory would be demonstrated. Of course, such a preference would require a well-ordered system of legal rules and the dependable enforcement of contracts. Another conclusion that can be drawn is that on the stockholder theory, everyone can benefit from corporate activity without the need for management to secure each group’s interest. If a firm is like a market, in which everyone gains from economic transacting without anyone being responsible for ensuring this outcome, then it is not necessary for managers to assume responsibility for ensuring that everyone benefits. Therefore, from the premise that corporate activity should benefit all stakeholder groups, it does not follow that ensuring this outcome is a task for *management*. The alternative of contracts and legal rules, which do not involve management action but are secured in a market that is supported by a sound legal system, may achieve this end more effectively.

## WRITING PROMPT

### A Rising Tide for All

Explain whether you agree with the argument that focusing primarily on the interests of shareholders also serves the interests of all stakeholders in the end. Within the stakeholder model, what could replace shareholder wealth as the objective of management?

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**RETURN TO STAKEHOLDERS** The second point of difference between the two theories involves the determination of a rightful return to non-shareholder stakeholders. Shareholders receive the profits of a corporation, while employees obtain wages, suppliers’ bills are paid, bondholders are owed principal and interest payments, and so on. The form of the return is not in question, but the amount is. Hence, the question:

Who or what should determine what each group receives in return for participating in the wealth-creating activities of a firm?

This question concerns fairness or justice in distribution. Broadly speaking, there are two questions to be asked in any economy: How to *produce* wealth and how to *distribute* it. Generally, decisions about production are made in a market on the basis of economic considerations. On the stockholder theory, the market also determines how wealth is to be distributed, but the

resulting distribution may not be fair. The stakeholder theory makes the just distribution of wealth a task of management by requiring managers to balance competing stakeholder interests. Not only does stakeholder theory give no guidance on how this balancing is to be done, but managers also have neither the ability nor the authority to determine a fair distribution. It is not only unreasonable to expect managers, who have enough responsibility making decisions about how to produce wealth, to handle questions about how it should be distributed, but it is also dangerous in a democracy to allow unelected managers to make such crucial decisions. Decisions about the distribution of wealth that depart from market outcomes should be made, for the most part, by governments through the political process, and not by managers of business organizations.

The answers of the stockholder theory to the two questions about protecting stakeholders and determining their just return are straightforward:

- The best means for protecting each group's rightful return are contracts and legal rules, and
- the return that each group has a right to receive is the market value of its contribution.

For example, employees typically work under legally enforceable contracts that specify their wages and other conditions of employment, and any disputes arising from a contract can be litigated in court. In addition, legal rules, mainly those of labor law, supplement employees' contracts to provide further protection. Similarly, suppliers and consumers are protected by sales contracts, as well as the body of commercial law, and securities law and the law of corporate governance protect the interest of investors in the operation of a firm. By contrast, stakeholder theory relies on managerial discretion both to protect each group's interests and to determine what return they should receive. In the stakeholder-managed firm, the tasks of protecting group interests and balancing their interests fall to corporate managers.

The main conclusion to be drawn from this discussion is that the familiar model of shareholder control of corporations is not only dominant in a market economy but is also justified, even though the shareholders need not be investors but could be any group, including employees, customers, or suppliers. In the American system of corporate governance, the control of corporations is left largely to the choices that each group makes through contracting in a market. Through such market contracting, each group is able to protect its interest and gain its rightful share of the wealth created by engaging in economic production. The stockholder model of corporate governance is better able than the alternative of a stakeholder firm to best serve the interests of all stakeholder groups.

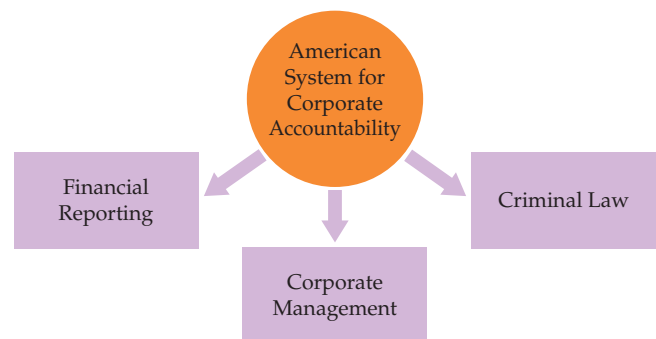
## 13.2: Corporate Accountability

### 13.2 Critique how financial reporting, corporate management roles, and the law function to prevent fraud and other kinds of corporate misconduct, and how flaws in the system have allowed major scandals

The recent scandals at Enron, WorldCom, and other companies were not the result of misconduct by a few individuals. They revealed major weaknesses in the systems of corporate control by which corporations are held accountable. The collapse of Enron, as well as WorldCom, involved fraudulent conduct by employees that evaded the controls ordinarily imposed on corporations by financial reporting requirements and oversight by executives and the board of directors. The Sarbanes-Oxley Act of 2002 (SOX), which was passed in the wake of Enron's collapse, reflected the belief of Congress that there were deep flaws in the American system of corporate accountability. The various provisions of SOX thus address the three major components of the American system for holding corporations accountable:

- financial reporting,
- corporate management, and
- criminal law.

**Figure 13.1** Components of Corporate Accountability



This section examines how each of these three forms of accountability function to prevent fraud and other kinds of corporate misconduct, and what weaknesses have permitted some major corporate scandals.

### 13.2.1: Financial Reporting

Enron's filing for bankruptcy on December 2, 2002, followed more than two months of revelations about the company's declining financial situation. When third-quarter earnings were reported on October 16, 2001, Enron announced that it was writing down the value of certain



investments by \$1.01 billion and that investor equity had shrunk by \$1.2 billion. More bad news followed on November 8 when the company revealed that its net income dating back to 1997 was \$586 million less than had been previously reported, due to improper accounting practices. When investors realized that Enron's reported income had been greatly exaggerated and that large amounts of debt had been hidden in dubious off-balance-sheet partnerships, all trust was eroded and the company's stock lost almost all value.

Enron's collapse was due not merely to bad business decisions that had been hidden from investors but also to a plundering of the company by insiders.

### What does this case illustrate about a company's financial reports?

The first line of defense against incompetence and outright criminality by corporate executives is a company's financial reports. The law requires that public companies prepare financial statements that present a fair and accurate picture of their financial condition, and these statements must be audited and attested to by a certified public accounting firm. Although audited financial statements are intended primarily to aid investors in making sound investment decisions and to increase the efficiency of financial markets, they also serve as an important check on management by making corporate operations more transparent. The ability of the market to react swiftly to changes in a company's situation makes it an effective monitor of managers' performance. Because investors rely so heavily on financial reports, they are also tempting vehicles for committing fraud. By presenting a false picture of a company's financial condition, executives can cover up poor performance and continue to receive lavish compensation. In many of the recent scandals, fraudulent accounting also enabled executives to dump much of their stock before bad news became public.

**ACCOUNTING AND AUDITING** Accounting is the recording and presentation of the financial transactions of an organization. Any organization, whether it is a business corporation, a not-for-profit organization, or a government unit, must keep track of its revenues and expenditures and compile this information in ways that provide managers with an understanding of the organization's financial condition. Accountants also compile an organization's financial information in reports that are presented to outside parties, such as creditors from whom the organization is seeking loans or the government, which requires that certain information be disclosed. All public companies are required by law to issue an annual report that details all assets, liabilities, revenues, and earnings in a consolidated balance sheet and income statement. In the United States, all accounting must be done in accord with established rules, known as generally accepted accounting principles (GAAP). Each country has its own version of GAAP, and

there is an emerging set of International Financial Reporting Standards (IFRS).

Auditing is an inspection of an organization's accounting records to determine their accuracy, completeness, and reliability. This inspection may be conducted inside the organization by managerial accountants or internal auditors, who are employees of the organization, or by outside, independent public auditors, who are certified public accountants (CPAs). In addition to inspecting an organization's financial accounting records, a CPA conducting an independent audit also examines the organization's financial accounting system and offers a report or opinion about both the accounting records and the accounting system. The independent auditor's report or opinion may be *unqualified*, which means that the organization's financial records fairly represent its financial condition and have been prepared according to GAAP, or *qualified*, which indicates either that the audit was not complete in scope or that GAAP was not followed completely. An independent public audit should be conducted in accord with Generally Accepted Auditing Standards (GAAS).

If corporate accounting and auditing were properly done, then fraud and other kinds of financial wrongdoing would be difficult to commit, and detection would be easy. Individual accountants and auditors, being human, are subject to ethical lapses; but, more importantly, there are certain structural problems with the practices of accounting and auditing that impair their effectiveness as a first line of defense against financial scandals.

### WRITING PROMPT

#### Auditing and Quality Control

Given that financial fraud occurs even with the presence of outside auditors, what steps do companies need to take in order to make sure that their financial statements remain accurate and trustworthy? How can a company better support the role of an outside auditor?

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**JOB PRESSURE** Managerial accountants and internal auditors, who are employees of a company, and the outside CPAs, who are engaged by the client company, are subject to intense pressure to achieve the financial picture that top executives want to convey. Often the pressure comes to meet earnings expectations in order to maintain a company's stock price or allow executives to make bonus or stock option targets. Such "earnings management" is possible because accounting rules allow great flexibility in their application. This flexibility is permitted so that companies can choose the accounting treatments that provide the fairest representation of their financial condition. However, a

company's own accountants and its CPA firm may be pressured to go along with accounting treatments that give an inaccurate or misleading picture of the company's financial condition but serve management's interest.

Arthur Levitt, a former chairman of the SEC, addressed the abuse of the flexibility in the accounting system with a call for higher ethical standards:

Our accounting principles weren't meant to be a strait-jacket. Accountants are wise enough to know they cannot anticipate every business structure, or every new and innovative transaction, so they develop principles that allow for flexibility to adapt to changing circumstances. That's why the highest standards of objectivity, integrity and judgment can't be the exception. They must be the rule.<sup>27</sup>

Of course, accountants may also be pressured to approve accounting treatments that are not in accord with GAAP, as when WorldCom personnel were ordered to record accruals as revenue and line charges as capital expenses. Such cases require accountants to have the moral courage to resist. CPAs are not employees who can be fired for failing to please management; but CPA firms are still selected by management, and they have a strong incentive to please the client in order to be retained. Enron, for example, was one of Arthur Andersen's most valued clients, and the company succeeded in having accountants who objected to Enron's accounting removed from the Enron team.<sup>28</sup>

**CONFLICT OF INTEREST** CPA firms have many interests besides serving clients, which put them in conflict-of-interest situations. In addition to a desire by a firm to retain clients, individual CPAs may have a financial relationship with the company being audited by, for example, owning stock in that company or a company doing business with it. The CPA firm may also have other clients who have business relationships with or who are competitors of the company being audited. Any such relationships might impair the objectivity and independence of the CPAs engaged in an audit. For this reason, "The Code of Professional Conduct of the American Institute of Certified Public Accountants" requires CPAs to maintain objectivity and independence and be free of conflicts of interest.

The AICPA code specifically prohibits having "any direct or material indirect financial interest" in an audit client and any loan from the company or anyone related to it. This prohibition does not address the conflict that results when auditors take positions with a company that he or she formerly audited. The prospect of an attractive job with an audit client might influence an auditor's judgment. Indeed, a number of top executives at Enron had previously been with the Houston office of Arthur Andersen on the Enron account.

CPA firms encounter two other sources of conflicts of interest. One source arises when accounting firms provide

both auditing and consulting services to a client. Critics of this arrangement charge that since consulting services are usually more lucrative than auditing, firms have an incentive to avoid alienating clients by conducting aggressive audits in order to maintain the consulting engagements. The other source of conflict results from the dual loyalty of auditors. The word "public" in "certified public accountant" indicates that an audit is conducted to serve shareholders and the investing public. However, CPAs are engaged and compensated by the companies they audit, thus making these companies the clients of the accounting firm.

Since the interests of a client company and the public can be different, should the CPA firm balance these interests in some way or regard the interest of the public as paramount?

In 1984, the U.S. Supreme Court declared the public interest paramount:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes allegiance to the corporation's creditors and stockholders as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>29</sup>

The ideal of total independence from the client and complete fidelity to the public is very difficult to achieve in practice, in view of the competition for clients and the high fees they generate. These two sources of conflict of interest have led to proposals—so far unimplemented—that auditing and consulting services be provided by separate firms and that audits be publicly funded.

## WRITING PROMPT

### Conflicts of Interest and the "Big Four"

There are four international accounting and auditing organizations that dominate this sector of the financial services market: Deloitte Touche Tohmatsu, PricewaterhouseCoopers, Ernst & Young, and KPMG. (Before the Enron scandal, Arthur Andersen belonged to this group, which was then known as the "Big Five.") Do you think the dominance of so few firms increases or decreases the likelihood that there will be conflicts of interest—or could it be helpful for preventing them? Explain your reasoning.

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**CONFIDENTIALITY** Accountants have a strict duty of confidentiality that prevents them from disclosing any confidential information about a client without that client's

consent, except when required to do so by law. One such legal requirement is that an accounting firm that withdraws from an auditing engagement because of suspected wrongdoing by the client must file a report with the SEC detailing the reasons for the withdrawal. However, any other information about suspected wrongdoing should not be disclosed to other parties, including any companies that are harmed by the wrongdoing or another accounting firm that takes over the engagement. An example of the difficulties that a duty of confidentiality creates is provided by the experience of Arthur Andersen in the late 1960s.

**Example:** After an Arthur Andersen team audited Fund of Funds and found no problems, the same team began an audit of King Resources, which had business dealings with Fund of Funds. The auditors discovered that King Resources had sold properties to Fund of Funds at inflated prices. If Andersen informed Fund of Funds of the fraud, then King Resources might sue for breach of confidentiality. However, if Andersen said nothing, then Fund of Funds might sue Andersen for concealing the information. Andersen chose the latter course and was successfully sued by Fund of Funds for failing to disclose the inflated prices.<sup>30</sup>

**THE EXPECTATIONS GAP** The ability of auditors to detect fraud and other wrongdoing is limited by what auditors are expected to do and what they can reasonably accomplish. An audit conducted according to GAAS is not intended to be a forensic audit to uncover fraud; rather, it is designed to provide reasonable assurances that a company's records are accurate representations. Auditors examine the records prepared by the company's own accountants, and they test only selected transactions. If a company's accounting system is judged to be adequate, then less effort is expended in testing. A "clean" or unqualified opinion attests only the accuracy of the company's books and not to the company's solvency or future prospects. Because the public expects auditors to do more than this and accepts a "clean" opinion as a "clean bill of health," there is an "expectations gap" between what the public expects of auditors and what auditors actually do. The expectations gap could be closed so as to make auditors more effective at detecting fraud, but doing so would involve greater costs and change the nature of auditing. The question from a regulatory point of view is whether auditors or federal and state investigators can better serve as detectors of fraud.

The Sarbanes-Oxley Act of 2002 contains a number of provisions that address the problems with accounting and auditing.

- Title I created the Public Company Accounting Oversight Board, which has the power to review audits, set additional auditing standards, and sanction firms for conducting inadequate audits.

- Title II, titled "Auditor Independence," prohibits the provision of certain nonaudit services to an audit client, requires that the lead audit partner for any client be rotated at least every five years, and imposes a one-year waiting period before accepting employment with an audit client.
- Title IV, "Enhanced Financial Disclosures," requires that publicly traded companies develop their own systems of internal control over financial reporting and provide periodic reports on the effectiveness of those systems.

In signing SOX, President George W. Bush declared, "This law says to corporate accountants: the high standards of your profession will be enforced without exception; the auditors will be audited; the accountants will be held to account."<sup>31</sup>

### WRITING PROMPT

#### Bridging the Expectations Gap

A decade after the Sarbanes-Oxley Act of 2002 was enacted, the news media reported that according to financial insiders, the law had helped to improve the integrity of corporate financial reporting and reduce instances of fraud. Explain whether you think this act of government was necessary to reduce financial misconduct. Would cases like Enron have prompted investors and other market actors to demand better financial reporting and auditing without new laws?



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## 13.2.2: Executives and Directors

The main locus of decision making in corporations is in director boardrooms and executive suites. Accordingly, directors and executives, especially the chief executive officer (CEO), play a critical role in ensuring corporate accountability.

**Example:** Although the Enron board of directors included many distinguished, competent, and diligent individuals and exemplified many good corporate governance practices, its members twice voted to rescind the company's conflict-of-interest policy so that the chief financial officer (CFO), Andrew Fastow, could serve as the managing partner of several special purpose entities. These off-balance-sheet partnerships not only allowed Fastow to enrich himself at the expense of Enron shareholders but also created enormous risks of which the board was apparently unaware. The twin failures of the board of directors to exercise its proper oversight role and of the CFO to avoid flagrant conflicts of interest were major causes of Enron's collapse.

Another cause of the massive fraud at Enron lay with its other top executives, including the CEO, Jeffrey Skilling, and the chair of the board, Kenneth Lay. Skilling was convicted in 2006 of 19 counts of conspiracy, insider trading, obstruction of justice, and securities fraud and was sentenced to more than 24 years in prison, later reduced to 14. Lay was convicted in a joint trial with Skilling of 10 criminal charges, with a likely prison sentence of 20 or 30 years, but he died before his scheduled sentencing.

The example of Enron illustrates that top executives may be not only weak points in ensuring accountability in a corporation but also important subjects of accountability systems. Systems must be in place to ensure the accountability of both boards and executives as well as the effectiveness of their roles in holding others to account.

**ROLE OF THE CEO** The CEO of a company makes the most important decisions and thus effectively manages it. CEOs typically have the greatest amount of knowledge of any participant in decision making and so are in the best position to ensure accountability. In addition, CEOs have considerable influence in the selection and retention of board members, so that, to some extent, they are responsible only to themselves and hence in the greatest need to be held accountable.

The key to holding CEOs and other top executives to account is creating the right incentives. This is achieved by four main means.

- First, both officers and directors of a corporation have a legally imposed fiduciary duty to act in all matters in the shareholders' interest. Although this duty is legally enforceable in that officers and directors can be sued for breaches, both are protected by the business judgment rule that exempts them from suits for good faith business decisions. Moreover, successful suits for breach of fiduciary duty are generally limited to egregious acts of incompetence or self-dealing, so that fiduciary duty provides a relatively weak incentive for being accountable.
- Second, executives' interests can be effectively aligned with those of shareholders by a substantial ownership interest or performance-based compensation through bonuses and/or stock options. In this way, CEOs act more like shareholders because they, in fact, become significant shareholders themselves and not merely hired professional managers. Indeed, managers with an ownership stake may have a greater incentive than shareholders to operate a firm profitably since their investment is less diversified than that of shareholders.
- Third, a competitive labor market for CEOs and other executive positions places a premium on a manager's success in his or her current job. Even if it is relatively

rare for an executive to hold multiple CEO positions, a CEO has a strong incentive to avoid dismissal, and new CEOs are drawn from the ranks of aspiring executives who have incentives to excel. Thus, the market for CEO talent perhaps works best at lower levels among potential CEOs, who help support the current one.

- Fourth, an active market for corporate control serves to discipline underperforming or self-serving management by the threat of a takeover. Although hostile takeovers are relatively rare in Europe and Japan and increasingly more difficult to wage in the United States, greater pressure by institutional investors has been successful, in many instances, in producing the same kind of change that a hostile takeover would achieve.

**ROLE OF DIRECTORS** Corporate directors are elected by the shareholders to exercise their right of control in the operation of a corporation. In this role, directors select and monitor the CEO of the corporation, approve the company's overall strategic plan, and ensure that adequate control systems are in place. The board also exercises control through an audit committee that reviews financial reports, a nominating committee that recruits new board members, and a compensation committee that sets the compensation package for the CEO. In addition to its control responsibilities, the members of the board, who have wide experience and extensive connections, also provide advice to the top-management team and offer crucial outside resources. Board members are characterized as inside or outside directors depending on whether they are currently executives of the corporation, and outside directors are designated as independent if they have no relationship with the corporation other than service on the board. In the United States, the chairman of the board is often the CEO—called "CEO duality"—although the two roles may be separated, and they often are in other countries.

In most of the recent scandals, boards of directors have not been complicit in any wrongdoing but have been unaware of what was occurring in the companies they supposedly controlled. For some directors, this ignorance was due to a lack of attention, a lack of competence, a lack of independence, conflicts of interest, or some combination of these four factors. Board members are often chosen by the CEO, and probably too many of them were close associates of the CEO, celebrities who brought little but their name to the board or else CEOs themselves who did not have the time to devote their full attention. However, much of the failure of corporate boards to prevent wrongdoing, like the failure of accountants and auditors, was due to structural features, many of which were addressed by SOX.

Among the factors contributing to failed board performance is a low percentage of independent directors. A sign of good board practice is a majority of independent

directors with crucial committees, most notably the nomination, compensation, and audit committees, constituted entirely by independent directors. Board members cannot be expected to know about misconduct in the organization, but they are responsible for having control systems and accounting procedures capable of detecting it. Some boards had failed to evaluate the adequacy of the systems and procedures in place. Although board members must have the confidence to leave a CEO free to operate a company, they should also exercise greater independence by, for example, conducting some executive sessions without the CEO and other chief officers present. Some have proposed to increase board independence by separating the roles of CEO and chairman or, at least, appointing a designated or lead director to guide the independent members.

Good board practice also calls for the audit committee to meet with the independent auditors in an executive session to satisfy themselves that there are no financial irregularities. Some of the other proposals for reform include reducing the number of boards on which directors sit, reducing the number of members on a board, increasing the number of meetings held annually, and increasing the amount of work done by committees. Increasing the compensation of board members and including stock grants and stock options have been proposed as ways of providing greater incentives for them to focus on protecting shareholder interests.

A number of provisions in the Sarbanes-Oxley Act address the problems of inadequate executive and board oversight. Among the highlights:

- SOX requires the CEO and the CFO to certify that they have reviewed every report filed with the SEC and that, to the best of their knowledge, the report does not contain any material misstatements.
- Section 404 requires every public company to assess annually the adequacy of its internal control system and its procedures for financial reporting. The audit committee of the board is required by SOX to be composed entirely of independent directors, and at least one member must be a “financial expert.”
- SOX also requires that the independent auditor meet with the audit committee of the board and that the committee be solely responsible for selecting, compensating, and monitoring the independent auditor.
- Finally, a significant source of abuse was removed by banning corporate loans to company executives.

Although SOX has been subjected to considerable criticism, especially for the cost of complying with Section 404, the legislation represents a significant effort by Congress to improve the effectiveness of executives and directors in preventing the kinds of misconduct that occurred at Enron and other companies.

## WRITING PROMPT

### The Sarbanes-Oxley Act

Review the sample SOX provisions listed above. What ethical principle or general requirement is each provision intended to address? Are you surprised that any of these tasks or prohibitions were not already dictated by law? Or do you think any of the provisions are unnecessary? Explain.

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## 13.2.3: Criminal Prosecution

The law, both criminal and civil, is a major means of holding not only individuals but also corporations accountable. The successful criminal prosecutions of Jeffrey Skilling of Enron and Bernie Ebbers, the CEO of WorldCom, illustrate the power of the law to achieve accountability. Criminal and civil law is applied not only to individuals but also to corporations. Arthur Andersen, the accounting firm that had signed off on Enron’s faulty financial reports, was indicted on March 14, 2002, for obstruction of justice in shredding documents; and when the firm was found guilty three months later, it, too, collapsed like Enron before it.

Fraud and conspiracy to commit fraud are criminal offenses for which both individuals and corporations can be prosecuted. Other misdeeds for which corporations have been prosecuted criminally include unsafe products and working conditions, bribery and corruption, and willful pollution. Criminal prosecution, along with financial reporting and the roles of executives and directors, serves as a means for holding corporations accountable. Individuals and corporations may also be prosecuted for civil rather than criminal offenses. Generally, a criminal offense involves some harm to the state, whereas a civil offense arises from the violation of some regulation or a private right. Crimes are generally more serious than civil offenses and usually result in a more severe sanction or penalty. Prosecutors often have the choice of bringing a criminal or a civil indictment against an individual or a corporation. Criminal prosecutions are state actions, but civil suits may be brought by either the state or private individuals.

**THEORETICAL PROBLEMS** The main theoretical problem with prosecuting corporations was neatly stated by an eighteenth-century Lord Chancellor of England who was quoted as saying, “Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?”<sup>32</sup> Unlike natural persons, corporations are legal fictions that appear to lack the two essential elements for criminal liability: a mind that has the necessary knowledge and intent and a body that can perform the criminal act. In law, these elements are *mens rea* (a guilty

mind) and *actus reus* (the guilty act). In addition, a corporation also lacks a body that can be punished; it cannot be imprisoned, for example. However, corporate decision making exhibits features apart from the actions of the individuals who make up a corporation that may be described by saying the corporation knows, intends, and so on. Similarly, there are actions performed by individuals that may be attributed to a corporation, especially when that person is acting in an organizational role.

Because the ascription of mental states and actions to corporations is speculative, legislators and judges have been ambivalent about the applicability of corporate criminal law. In practice, proving the necessary elements of *mens rea* and *actus reus* is difficult. Corporate criminal action has been traditionally established by the legal doctrine of vicarious liability, by which a principal may be held liable for the actions of his or her agent. However, this doctrine might unfairly hold a corporation liable when an employee acts outside the scope of his or her role. It is often difficult to determine when an employee is acting on behalf of the corporation or on his or her own. Moreover, the main punishment that can be imposed on a corporation is a monetary fine, which is borne by the shareholders, who may be innocent of the crime and victims as well.

**PRACTICAL PROBLEMS** In addition to the theoretical problems, prosecutors face enormous practical difficulties in building a case against individuals or a corporation for white-collar crimes, given the diffuse nature of corporate decision making and corporate action and the inaccessibility of information.

The fraudulent transactions at Enron typically involved many people, each with responsibility for only one small part of the paperwork involved, and none of these participants may have had knowledge of the full scope of any given transaction. Absent a “smoking gun” that shows knowledge and intent by specific individuals, criminal charges against corporations are not easily proven in court. To overcome this problem, the American legal system has shifted emphasis to a corporation’s pre- and post-offense behavior. The aim of the law has been to prevent misconduct before it can occur and to encourage cooperation by the corporation to settle charges quickly and expose the individuals responsible.

This new cooperative approach is the result of two developments:

- the federal Sentencing Guidelines for Organizations, implemented in 1991, and
- the Principles of Federal Prosecution of Business Organizations, which was promulgated first in 1999.

The sentencing guidelines, discussed later in this chapter, guide judges in the sentencing of organizations, and the principles, issued by the U.S. Department of

Justice, direct federal prosecutors in decisions about whether to charge corporations with crimes. Under the principles, corporations are less likely to be criminally prosecuted if they voluntarily cooperate with investigators and do not shield employees.

The main effects of these two influential documents have been to encourage organizations to implement ethics programs, disclose wrongdoing, admit guilt, provide requested documents, fire employees who refuse to testify, and withhold support for employees’ legal expenses. Although the cooperative approach may prevent misconduct before it occurs and facilitate the prosecution of crimes that are committed, it may raise ethical issues of its own. John Hasnas has argued that in cooperating with investigators, corporations may violate employees’ rights to confidentiality and privacy and destroy the trust that is necessary for corporations to function.<sup>33</sup> If this is the case, then company executives are faced with a choice between protecting the company from legal liability and acting ethically toward their employees.

#### WRITING PROMPT

##### Who Takes the Fall?

Consider the extent to which any individual in a large corporation should be held accountable for criminal misconduct. For instance, who should take responsibility for a fraudulent report: the person who ultimately signed off on it or the person who prepared it? Explain your reasoning.

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## 13.3: Corporate Compliance

### 13.3 Evaluate the components of corporate ethics programs, the federal guidelines designed to punish and prevent misconduct, and how adopting a code of ethics benefits companies

Corporations are increasingly paying attention to ethics in the conduct of employees at all levels of the organization. Unlike the emphasis on corporate social responsibility, which focuses on the impact of business activity on society at large, the corporate ethics movement addresses the need to guide individual decision making and to develop an ethical workplace environment. Much of the impetus in the United States has come from recognition of the dangers posed by individual misconduct. However, unethical business practices are seldom due to a lone rogue employee but usually result from factors in the organization.<sup>34</sup> Ethics programs are designed, therefore, to create an organization that fosters ethical conduct. No program can prevent

momentary lapses of judgment, much less intentional wrongdoing, and ethical misconduct has occurred in companies with exemplary ethics programs.

This section examines corporate ethics programs in regard to two questions:

- What are the standard components of an ethics program?
- What leads corporations to adopt a program, and what do they expect to achieve?

Some companies have adopted ethics programs in response to serious scandals, whereas others seek to prevent scandals before they occur. In particular, the corporate ethics movement has been spurred by the Federal Sentencing Guidelines, which offer lenient treatment for convicted organizations with an effective ethics program. These are primarily defensive strategies aimed at legal compliance. However, many corporations strive for a higher level of conduct in the belief that a reputation for integrity provides a strategic advantage. Like all other corporate initiatives, though, ethics programs represent an investment that must be justified, and so we need to take a critical look at their benefits and also at possible objections to them.

### 13.3.1: Program Components

Every organization has an ethics program of some kind, although it may not be recognized as such.<sup>35</sup> In the broadest sense, an ethics program consists of the rules and policies of an organization and the procedures and systems for motivating and monitoring ethical performance. Rules and policies include the culture and values of an organization and formal documents, such as mission statements, codes of ethics, policy and personnel manuals, training materials, and management directives. Compliance with rules and policies is secured by various procedures and systems for orientation, training, compensation, promotion, auditing, and investigation. These procedures and systems are essential functions in any business organization. Companies with an identifiable ethics program are distinguished by the emphasis that they place on these functions and the manner in which they address them.

The components of a corporate ethics program generally include:

- a code of ethics,
- ethics training for employees,
- means for communicating with employees about matters of ethics,
- a reporting mechanism for enabling employees to report alleged wrongdoing,
- an audit system for detecting wrongdoing, and
- a system for conducting investigations and taking corrective action.

In addition, more than 500 U.S. corporations have established the position of ethics officer to oversee all aspects of an ethics program. Many companies without an ethics officer still assign the main responsibilities to one or more high-level executives.

This list of components does not reveal the range of corporate ethics programs. At one end of the spectrum are programs designed merely to secure compliance with the law and with the company's own rules and policies. The goals are to prevent criminal conduct and violation of government regulations on one hand, and to protect the company from self-interested action by employees on the other. Compliance of this kind is essential in any organization, but some corporations take a broader view of ethics. At the other end of the spectrum are ethics programs that communicate the values and vision of the organization, seek to build relations of trust with all stakeholder groups, and emphasize the responsibility of each employee for ethical conduct.

Lynn Sharp Paine describes this latter kind of program as an *integrity strategy* in contrast to the *compliance strategy* that is represented by the former kind.<sup>36</sup> While a compliance approach imposes standards of conduct on employees and attempts to compel acceptable behavior, a program guided by integrity aligns the standards of employees with those of the organization and enables them to act ethically. An integrity strategy seeks to create conditions that foster right action instead of relying on deterrence and detection. These conditions are created by the whole management team rather than being relegated to lawyers or others in compliance, and by employing the whole resources of the organization. In particular, the full range of procedures and policies, the accounting and control systems, and the decision-making structures of the corporation are utilized for the end of fostering right conduct. An integrity strategy also attempts to motivate employees by appealing to their values and ideals, rather than relying solely on material incentives.

### 13.3.2: Program Benefits

**The main benefit of an ethics program is to prevent ethical misconduct by employees.** Employee misconduct is costly to companies not only in direct losses but also in those sustained from a tarnished reputation. The total cost to Sears, Roebuck, and Company for settling suits nationwide over allegations that its Sears Auto Centers made unnecessary repairs has been estimated to be \$60 million (see Case: Sears Auto Centers). In addition, the trust of consumers that enabled the company to enter the competitive auto repair market was seriously damaged.

The financial services industry has produced some examples of very costly misconduct.

- A bond-trading scandal at Salomon Brothers in 1991 cost the firm almost \$1 billion.

- In 1994 Prudential Securities agreed to pay fines and penalties in excess of \$700 million for crimes committed in the sale of limited partnerships in the 1980s.
- A Japanese copper trader hid losses estimated at \$2.6 billion from his employer, Sumitomo Corporation.
- Nicholas Leeson, a 29-year-old, Singapore-based trader for Barings Bank, destroyed this venerable British firm by losing more than \$1 billion in unauthorized trading.
- In 2008, a rogue trader at Société Générale lost more than \$7 billion for the French bank.

In some instances, the main loss from employee misconduct has been the company's reputation. For example, NYNEX adopted an ethics program after learning that between 1984 and 1988, its purchasing unit had hosted an annual convention in Florida for suppliers and company employees featuring strippers and prostitutes. The public exposure of these events—dubbed “pervert conventions” by the press—came at the same time when the struggling company was seeking an unpopular \$1.4 billion rate increase from the New York State Public Service Commission.

**A second benefit of ethics programs is that they provide a managerial tool for adapting the organization to rapid change.** Among the factors that have led corporations to adopt ethics programs are increased competition, the development of new technologies, increased regulation, recent mergers and acquisitions, and the globalization of business. The problems at NYNEX, for example, were not confined to risqué parties. The breakup of AT&T in 1984 had forced NYNEX and all Baby Bells to compete in an unfamiliar environment that required new ways of doing business. NYNEX needed to provide individual guidance to employees during a period in which all the rules were being rewritten. Mergers and acquisitions also disrupt familiar routines and create the need to develop new ones rapidly. Finally, a formerly domestic company that becomes a global enterprise must not only set the rules for its own employees' behavior abroad but must also mesh its conduct with that of foreign customers, suppliers, and joint venture partners.

**Third, ethics programs help organizations manage relations with external constituencies.** An ethics program serves to reassure customers, suppliers, investors, and the general public of the serious intent of a corporation to adhere to high ethical standards. It is no accident that the first ethics programs were developed by defense contractors, which have only one customer, namely, the Department of Defense. The Defense Industry Initiative, which commits each signatory to develop an ethics program, was an attempt to assure this all-important customer of its trustworthiness after defense contractors that falsified records were fined and forced to make restitution. Problems often develop when a company and its suppliers or

vendors operate by different standards, and so a company's ethics program helps make its standards known. For example, some companies notify suppliers of their policy on gift giving and ask them to respect it.

The existence of an ethics program is an assurance not only to socially responsible investors, who look for such indicators, but also to shareholders generally, who want to avoid the cost of major scandals.

**Example:** The shareholders of Caremark International, Inc., a health care provider, sued the individual members of the board of directors for failing to prevent criminal violations that cost the company \$260 million. In deciding this case, the Delaware Chancery Court held in 1996 that directors have a fiduciary duty to the shareholders to ensure that the corporation's reporting systems are reasonably well designed to provide management with sufficient information to detect violations of law.<sup>37</sup> The *Caremark* decision has been described as a “wake-up call” to directors that they may be personally liable for their failure to ensure that a corporation has an adequate compliance system in place.<sup>38</sup>

Of course, an ethics program is only one means for securing compliance. However, the *Caremark* decision, combined with the Federal Sentencing Guidelines, provides a strong incentive for developing one.

### 13.3.3: Federal Sentencing Guidelines

In 1984, Congress created the U.S. Sentencing Commission in order to bring greater uniformity and effectiveness to the sentences that judges impose for federal crimes. In developing new guidelines, the Sentencing Commission departed from prevailing practices by holding organizations responsible for the conduct of individual decision makers and creating incentives for organizations to prevent misconduct by their members. Under the Federal Sentencing Guidelines for Organizations, which took effect in 1991 and were revised in 2004, the sentence for an organization that has been convicted of a federal crime depends, in part, on the effort that has been made to prevent and detect criminal wrongdoing, including the adoption of an “effective ethics program.”

The federal sentencing guidelines have the dual aim of imposing a just sentence on any convicted organization and influencing the conduct of all organizations. The former aim is achieved by guidelines that base the penalty on the seriousness of the offense and the culpability or blameworthiness of the organization. The guidelines provide not only for fines that punish an organization but also for restitution to the victims, and the fines can be set so as to wipe out any gain for an organization from its criminal activity. In addition, the severity of the fines, which can reach



\$290 million or the higher of the gain to the organization or the loss to the victims, provides a powerful incentive for organizations to take preventive steps and to cooperate in an investigation.

**HOW THE GUIDELINES WORK** The first step in applying the guidelines is determining a base fine. This amount is generally taken from a table that ranks crimes according to their seriousness and assigns a monetary amount to each level. The base fine ranges from \$5,000 for a level 6 offense or lower (embezzlement, theft, bribery of a public official) to \$72.5 million for a level 38 offense or higher. Commercial bribery, for example, is a level 8 offense with a \$10,000 base fine, and money laundering is a level 20 offense with a base fine of \$650,000.

The base fine may then be either increased or decreased by a multiplier based on a “culpability score” (see Table 13.1).

**Table 13.1** Determining a Culpability Score

The culpability score, which ranges from 1 to 10, is determined by starting with 5 points and subtracting or adding points for certain factors, such as those listed below.

Points added to 5	Points subtracted from 5
+ 5 points if high-level personnel were involved in the wrongdoing	- 1 to 5 points for:
+ 3 points if the organization obstructed the investigation or prosecution of the crime	• self-reporting an offense
+ 2 points if similar misconduct had occurred before	• cooperation with investigation
	• existence of an ethics program
	• accepting full responsibility

The significant factor for the development of an ethics program is that a sentencing judge subtracts three points if the offense occurred “despite an effective program to prevent and detect violation of the law.” (This provision does not apply if high-level personnel were involved or if they delayed reporting the offense after becoming aware of it.)

As previously mentioned, for each culpability score, there is a range from which a judge can choose a multiplier that either reduces or increases the base fine. The minimum multiplier is 0.05, which reduces the fine imposed to 5 percent of the base fine. The maximum multiplier is 4.00, which quadruples the base fine. Hence, the highest fine is \$72.5 million (the highest base fine) multiplied by 4.00 (the highest multiplier), or \$290 million.

The highest fine imposed so far by using the Federal Sentencing Guidelines is \$340 million levied against Daiwa Bank in New York, even though the bank was a victim of unauthorized trading by an employee that cost the bank \$1.1 billion.<sup>39</sup> The charge against the bank was that officials had failed to inform U.S. officials within 30 days of the discovery of the loss as required by law. The bank officials engaged in the cover-up in part to avoid a decline in the bank’s stock price but also because they felt that they

needed time to understand what had happened and because the Japanese Ministry of Finance feared that disclosure would have an adverse impact on markets in Japan. However, if the bank had adopted an adequate compliance program, perhaps the loss would have been detected earlier with less severe consequences.

**EFFECTIVE ETHICS PROGRAMS** The Federal Sentencing Guidelines defines an effective ethics program as one “that has been reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct.”<sup>40</sup> The program need not prevent or detect every instance of wrongdoing, but the organization must have practiced “due diligence,” which involves the following steps.<sup>41</sup>

1. The organization must have established compliance standards and procedures that are reasonably capable of reducing misconduct.
2. Specific high-level personnel must have been assigned responsibility for overseeing compliance with the standards and procedures.
3. The organization must take due care not to assign substantial discretionary authority to individuals with a propensity to engage in illegal behavior.
4. Standards and procedures must have been communicated to all employees and agents through such means as publications and training programs.
5. The organization must have taken reasonable steps to ensure compliance by using monitoring and auditing systems and a reporting system that employees may use without fear of retaliation.
6. The standards must have been consistently enforced through appropriate disciplinary measures, including, as appropriate, the punishment of employees who fail to detect an offense by others.
7. After an offense has been detected, the organization must have taken all reasonable steps to respond appropriately and to prevent further similar offenses.

The specific actions involving these steps will depend on many factors, including the size of the organization, the nature of the industry, and the organization’s prior history.

Although the Federal Sentencing Guidelines provides a strong incentive for corporations to establish ethics programs and contains a good definition of an effective ethics program, questions have been raised about the overall approach of the guidelines and specific features of the definition. First, there is no solid evidence that ethics programs are more effective than other kinds of compliance systems in preventing illegal behavior. Some evidence indicates that misconduct occurs not because of ignorance about the standards for acceptable conduct but because of organizational pressures and the actions of peers.<sup>42</sup> To be effective,

therefore, an ethics program must go beyond setting and enforcing rules and include the goal-setting and reward systems of an organization. The need to move beyond the mere enforcement of rules was one reason why the federal sentencing guidelines were revised in 2004 to require that corporations develop an organizational culture that encourages ethical behavior, using wording that is similar to Paine's call for organizational integrity.<sup>43</sup>

Second, to the extent that ethics programs are not effective, the guidelines may encourage corporations to create highly visible "window dressing" programs at the expense of more substantive initiatives. Moreover, most large corporations already have compliance programs that would satisfy the guidelines' requirements, so that little is to be gained by offering a reduction in any fine. But small firms may be penalized for investing their more limited resources in a formal ethics program when other systems of control might be more effective in preventing misconduct.

### WRITING PROMPT

#### The Range of Corporate Ethics Programs

Recall the range of corporate ethics programs discussed earlier in Section 13.3.1, from those adopting a compliance strategy to those with an integrity strategy. Where on this scale would you place the type of program recommended by the Federal Sentencing Guidelines? Explain your reasoning.

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## 13.3.4: Codes of Ethics

The first step in developing an ethics program, and the only step that some companies take, is a code of ethics. The development of ethics codes for corporations is a relatively recent phenomenon, with most having been written since 1970.<sup>44</sup> In many instances, these codes replaced other kinds of documents, such as policy manuals, executive directives, and customary practices. An early prominent code of ethics was "The Penney Idea," a set of seven principles set forth by the merchandizing pioneer J.C. Penney in 1913.

A major impetus for the development of corporate ethics codes was provided by the influential National Commission on Fraudulent Financial Reporting (the "Treadway Report"), issued in October 1987. This report recommended,

Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. As a part of its ongoing oversight of the effectiveness of internal controls, a company's audit committee should review annually the program that management establishes to monitor compliance with the code.<sup>45</sup>

Since 2004, the New York Stock Exchange and NASDAQ have required listed companies to adopt and publish a code of ethics, and under the 2009 Sarbanes-Oxley Act, a publicly held company must disclose whether it has adopted a code of ethics for senior executives and explain any absence of a code.<sup>46</sup> Many companies, especially those with global operations, have voluntarily committed themselves to observe codes developed by non-business groups, such as the United Nations Global Compact and the OECD Guidelines for Multinational Enterprises.

**TYPES OF CODES** Codes of ethics vary widely, falling into three main types.

- The most common is a statement of specific rules or standards for a variety of situations. These are most often called codes of conduct or statements of business standards or practices.
- A second type is a statement of core values or the vision of an organization, sometimes called a credo or mission statement. These statements frequently include affirmations of the commitments of a company to key stakeholders, such as customers, employees, and the community.
- Third are corporate philosophies that describe the beliefs guiding a particular company. Perhaps the best known of these is Hewlett-Packard's "The HP Way." Corporate philosophy statements are generally written by the founders of businesses in emerging industries, such as computers, where new ways of doing business are needed.

Most codes of ethics combine elements of the first two types, but at least one firm, Levi Strauss & Company, has adopted all three kinds of statements.

#### What is the Levi Strauss code of ethics?

##### Levi Strauss's Ethical Guidelines

An Aspiration Statement describes what kind of company its members want it to be. A Code of Ethics explains the values and ethical principles that guide action. And finally, Levi Strauss has adopted a document entitled "Global Sourcing and Operating Guidelines," which contains very specific rules on working with business partners and choosing countries for operations.

A few weeks before the guidelines were officially adopted, Levi Strauss canceled a contract with a supplier in Saipan (a U.S. territory) after reports of human rights violations. Subsequently, the U.S. Department of Labor charged that the contractor worked the employees, mostly Chinese women, up to 11 hours a day in guarded compounds and paid them well below the Saipan minimum wage. The contractor settled the charges for \$9 million. One Levi Strauss manager observed, "If anyone doubted the need for guidelines, this convinced them."

In addition to company codes of ethics, there are many industry codes, generally adopted by a trade organization. These include organizations for the advertising, banking, direct marketing, franchising, insurance, and real estate industries.

Because a commitment to high ethical standards and self-regulation is integral to a profession, most professional groups have also developed ethics codes to which their members are generally required to subscribe. Among professions with codes of ethics are physicians, lawyers, accountants and auditors, architects, engineers, financial planners, public administrators, consultants, and journalists. Unlike company and industry codes of ethics, which are of recent origin, some professional codes are as old as the profession, as witness the Hippocratic oath for physicians, which dates from the fourth century B.C.

Use Figure 13.2 below to review the three main types of company codes of ethics.

- A written document enables an organization to clarify standards that may otherwise be vague expectations left to individual interpretation. Where there is disagreement on the appropriate standards, codes can achieve a measure of consensus, and where standards are lacking or in need of revision, codes enable an organization to create new ones. This is especially true for American corporations with foreign operations and relationships, although a code of ethics may need to be modified when applied abroad.
- Codes of ethics are an effective means for disseminating standards to all employees in an easily understood form.
- Finally, an effective code of ethics that is enforced in an organization provides employees with a tool for resisting pressure to perform unethical or illegal actions. A code of ethics may enable employees to do what they believe to be right.

**Figure 13.2** Codes of Ethics

Main Types of Codes of Ethics

Code of Conduct	Mission Statement	Corporate Philosophy
<p>A statement of specific rules or standards of conduct</p> <ul style="list-style-type: none"> <li>• The most common type of code identifies acceptable and unacceptable actions in a variety of situations</li> <li>• Also called <b>statements of business standards</b> or <b>statements of business practices</b></li> </ul>	<p>A statement of core values or the vision of an organization</p> <ul style="list-style-type: none"> <li>• These frequently include affirmations of the commitments of a company to key stakeholders, such as customers, employees, and the community.</li> <li>• Sometimes called a <b>credo</b> or <b>statement of values</b></li> </ul>	<p>A statement describing the beliefs guiding a corporation</p> <ul style="list-style-type: none"> <li>• Example: Hewlett-Packard's "The HP Way"</li> <li>• Generally written by the founders of businesses in emerging or evolving industries</li> </ul>

Even well-written codes of ethics have limitations, and badly written ones may have some unintended consequences. An emphasis on rules may create a rigid literalness that discourages judicious discretion. An especially dangerous situation is created when employees conclude that whatever is not prohibited is permitted. Some codes focus primarily on employee misconduct that can harm the company, which may lead to cynicism about the purpose of ethics. Some companies do not adopt a code of ethics because they believe that their way of doing business is best achieved by maintaining a strong culture and leading by example. Other companies believe that a code is inappropriate to their situation because extensive government regulation and

internal auditing are sufficient to deter both unethical and illegal behavior.

Studies of which companies adopt codes of ethics reflect these advantages and disadvantages. Codes are more prevalent in large companies, in companies with more complex structures, especially those that have grown rapidly or recently merged, and in companies that have high visibility and depend on their reputation.<sup>47</sup> Codes of ethics are less common among financial firms—investment banks, for example—in part because of the extensive government regulation, but also because of the strong incentive to monitor employee behavior closely.

There is no blueprint for writing a code of ethics. Both the procedure and content must arise from specific features of the company in question. However, some values, such as respect of the individual, fair treatment, honesty, integrity, responsibility, trust, teamwork, and quality, are included in typical codes, as are such topics

## WRITING PROMPT

### The Value of Codes

You are looking for a company to invest in and you have narrowed your choices down to several companies that differ only by the type of ethical code they have adopted. How would you compare these codes to make a final investment decision? Explain what elements you would require in a code, at a minimum, or whether your requirements would depend on the specific industry.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

**REASONS FOR ADOPTION** The reasons for adopting a code of ethics include those that lead companies to develop ethics programs. Even without a program, a code of ethics serves a number of valuable functions.

as conflict of interest, use of company resources, gifts and entertainment, confidentiality of information, and workplace behavior. There is one common trait of all successful codes of ethics, however: They have the clear support

of top-level management. A code is unlikely to be successful, though, if it is imposed from the top down. Ideally, everyone in a company should have “ownership” of the code.

## Conclusion: Governance, Accountability, and Compliance

The modern corporation is a remarkable form of economic organization that enables everyone in society to interact for mutual gain. Ideally, everyone should benefit from the wealth-creating power of business corporations. In order for corporations to function and provide their benefits, several problems must be solved. First, corporations must be legally structured so that investors, employees, customers, suppliers, and other groups that participate in productive activity are protected. This is part of the task for corporate governance. Second, corporations must be held accountable so that corporate executives do not engage in fraud or other wrongdoing. In addition to corporate governance, this task is addressed by accounting and auditing, a corporation’s board of directors, and criminal law. Third, there must be a control environment within the corporation to detect and deter employee misconduct. This is the task of the corporate compliance function, of which an effective ethics program is a major component. When an economic system combines all of these elements together—corporate governance, corporate accountability, and corporate compliance—the results can be a prosperous society. Where one or more of the elements are absent, the corporation cannot achieve its full potential.

shareholders’ rightful “voice” in corporate affairs. Similarly, the commonly accepted idea that directors on corporate boards have a strong fiduciary duty to act in the interests of shareholders is tested in “The Sale of Trans Union.” This landmark case in corporate law yields the surprising conclusion that it may not be in the shareholders’ interest to insist on high standards of fiduciary duty for board directors.

### Case: Sears Auto Centers

On June 11, 1992, the CEO of Sears, Roebuck and Company, Edward A. Brennan, learned that the California Department of Consumer Affairs (DCA) was seeking to shut down the 72 Sears Auto Centers in that state.<sup>48</sup> A yearlong undercover investigation by the DCA had found numerous instances in which Sears employees had performed unnecessary repairs and services. Officials in New Jersey quickly announced similar charges against six local Sears Auto Centers, and several other states, including Florida, Illinois, and New York, opened their own probes into possible consumer fraud. In the wake of this adverse publicity, revenues from the auto centers fell 15 percent, and the public’s trust in Sears was badly shaken.

### End-of-Chapter Case Studies

This chapter concludes with three case studies.

The “Sears Auto Centers” case illustrates a theme that occurs throughout this course: Wrongdoing in business is often the result of faulty practices, policies, and strategies, which create systemic, rather than purely individual, ethical vulnerabilities and which consequently require a systemic response rather than a focus merely on individual conduct. A welcome outcome of Sears’s experience in this case was the development of a model corporate ethics compliance program. The other two cases explore often misunderstood aspects of corporate governance. The popular but false idea that shareholders are the “owners” of a corporation, with virtually unlimited legal powers to direct their “property,” is tested in the case “Shareholder Rights at Cracker Barrel.” This case provides an opportunity to determine the limits of

### The Investigation

Sears Auto Centers, which were generally connected with a Sears department store, concentrated on basic “undercar” services involving tires, brakes, mufflers, shock absorbers, and steering mechanisms. Investigators from the DCA’s Bureau of Automotive Repair purchased old vehicles in need of minor repairs and disassembled the brakes and suspension systems. After examining and photographing each part, the investigators towed the automobiles to a shop where they requested a brake inspection. In 34 of 38 instances, Sears employees recommended unnecessary repairs and services, and some auto centers charged for parts that were not installed or work that was not performed. The average overcharge was \$235, but in two cases the amount overcharged exceeded \$500.

Brennan had been notified in December 1991 of early results from the investigation, and Sears executives

negotiated for six months with California officials. The company objected to the state's position that no part should be replaced unless it had failed and claimed that many repairs were legitimate preventive maintenance. For example, there is disagreement in the industry on whether brake calipers should be reconditioned whenever the pads are replaced. In addition, some of the automobiles used in the investigation showed signs of damage from worn parts that had already been replaced, thus leading mechanics to believe that repairs were needed. The DCA moved to revoke the licenses of all Sears Auto Centers in the state after the negotiations broke down over details of the financial settlement.

## A Systemic Problem?

California officials charged that the problems at the Sears Auto Centers were not confined to a few isolated events but constituted systemic consumer fraud. According to a deputy attorney general, "There was a deliberate decision by Sears management to set up a structure that made it totally inevitable that the consumer would be oversold." Until 1991, service advisers, who make recommendations to customers, were paid a flat salary, but subsequently their compensation included a commission incentive. The service advisers were also required to meet quotas for a certain number of parts and services in a fixed period of time. The new incentive system also affected the mechanics who perform the work on the customers' automobiles. Instead of an hourly wage that was paid regardless of how much work was done, mechanics now received a lower hourly wage that was supplemented by an amount based on the time required to install a part or perform a service. The company determined how long it should take to complete each job, and a mechanic could earn the former hourly wage only by finishing the work in the time specified. Under this system, slow workers would earn less than before, but a mechanic could also earn more by working faster than expected.

Commissions and quotas are commonly used in competitive sales environments to motivate and monitor employees. However, critics of Sears charge that there were not enough safeguards to protect the public. One former auto center manager in Sacramento complained that quotas were not based on realistic activity and were constantly escalating. He said that "sales goals had turned into conditions of employment" and that managers were "so busy with charts and graphs" that they could not properly supervise employees. A mechanic in San Bruno, California, alleged that he was fired for not doing 16 oil changes a day and that his manager urged him to save his job by filling the oil in each car only half-way. This illustrated, he said, the "pressure, pressure, pressure to get the dollar."

## Why did Sears switch to this incentive commission system?

The changes in the compensation system at Sears Auto Centers were part of a company-wide effort to boost lagging performance. In 1990, net income for all divisions, including Allstate (insurance), Coldwell Banker (real estate), and Dean Witter (brokerage), dropped 40 percent. Net income for the merchandising group, which included the department stores and the auto centers, fell 60 percent. Brennan, CEO since 1985, was under strong pressure to cut costs and increase revenues. Some dissident shareholders were urging the board of directors to spin off the more profitable insurance, real estate, and brokerage divisions and focus on the ailing merchandising group. Brennan's response was to cut jobs, renovate stores, and motivate people. The overall thrust, according to a story in *BusinessWeek*, was to "make every employee, from the sales floor to the chairman's suite focus on profits." Some critics of Sears attribute the problems at the auto centers to an unrealistic strategic plan that sought to wring more revenue out of the auto repair business than was possible. Robert Monk, who unsuccessfully sought a seat on the company's board, said, "Absent a coherent growth strategy, these sorts of things can happen."

## Company Response

At a press conference on June 22, 1992, Edward Brennan announced that, effective immediately, Sears would eliminate its incentive compensation system for automotive service advisers and all product-specific sales goals. Although he admitted that the company's compensation program "created an environment where mistakes did occur," Brennan continued, "We deny allegations of fraud and systemic problems in our auto centers. Isolated errors? Yes. But a pattern of misconduct? Absolutely not." He reaffirmed his belief that the California investigation was flawed and that Sears was practicing responsible preventive maintenance. He further announced that the company would retain an independent organization to conduct random "shopping audits" to ensure that no overcharging would occur. Sears also paid \$8 million to settle claims in California and gave auto center customers \$50 coupons that were expected to cost the company another \$3 million. The total cost, including legal bills and lost sales, is estimated to have been \$60 million.

On September 30, 1992, Sears revealed plans to spin off its three nonretail divisions, Allstate, Coldwell Banker, and Dean Witter, and to reorganize the merchandising group. A new CEO, Arthur C. Martinez, succeeded Brennan and began a turnaround of the company. In describing his vision, Martinez said, "I want to revisit and intensify the theme of our customer being the center of our universe." A cornerstone of Martinez's strategy, according to the *New York Times*, was "clean business ethics."

## SHARED WRITING: SEARS AUTO CENTERS

By requiring that “every employee, from the sales floor to the chairman’s suite focus on profits,” what message was CEO Brennan sending about the priority of ethical considerations compared to profits? Explain whether you believe that the lack of guidelines to protect Sears’ customers was an oversight or a deliberate omission.

Review and comment on at least two classmates’ responses, including one that opposes your own.

▶ **A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.**

Post

0 characters | 140 minimum

## Case: Shareholder Rights at Cracker Barrel

Cracker Barrel Old Country Stores, Inc., based in Lebanon, Tennessee, operated a chain of restaurants and gift shops, mostly in the South and Midwest, that featured southern-style cooking. In 1991, many Cracker Barrel shareholders, along with the company’s employees and members of the public, were outraged when at least 11 employees were dismissed for their sexual orientation. The gay and lesbian employees ran afoul of a new company policy that Cracker Barrel would no longer employ individuals whose sexual preferences “fail to demonstrate normal heterosexual values” or whose lifestyle was “contrary to traditional American values.” The fired employees had no legal protection since discrimination laws do not cover sexual orientation. The public could only boycott the restaurants by staying away, which many did. However, the outraged shareholders had a power that everyone else lacked: They were the owners of Cracker Barrel, and they could exercise their rights as owners to bring about change—or at least they thought they could.

### The Shareholder Resolution

The \$22 billion New York City Employees’ Retirement System, known as NYCERS, which owned 121,000 shares of Cracker Barrel stock worth around \$4.5 million, proposed a resolution to be voted on at the 1992 annual meeting. NYCER’s shareholder resolution was that the two words “sexual orientation” be added to the company’s equal employment policy and that the company take steps to ensure compliance with the amended policy. The legal basis of NYCER’s action was Rule 14a-8 of the 1934 Securities Exchange Act, which permits shareholders to propose resolutions to be included in the company’s proxy materials that are submitted to shareholders for a vote as part of an annual meeting. At the time, the right to propose a resolution was

accorded to any shareholder holding stock worth \$1,000; this amount has since been raised to \$2,000.

However, the shareholders were not allowed to vote on NYCER’s proposed resolution. Rule 14a-8 also permits a company to refuse to submit a proposed resolution to a shareholder vote under several conditions, one being that the resolution deals with the “ordinary business operations” of the company.<sup>49</sup> The management of Cracker Barrel judged that this shareholder resolution dealt with ordinary business operations and, thus, could legally be withheld from the company’s proxy materials. A company that rejects a proposed resolution is required to notify the Securities and Exchange Commission (SEC) of the action. The SEC agreed with the judgment of the Cracker Barrel management and issued a “no-action” letter affirming management’s decision.<sup>50</sup>

This decision by the SEC constituted a significant shift of position and created a storm of protest. In 1976, the SEC interpreted “ordinary business operations” in such a way that a resolution could be rejected only if it involved “business matters mundane in nature” and did not involve “any substantial policy or other considerations.”<sup>51</sup> Between 1976 and 1992, the SEC ruled that a number of resolutions dealing with equal employment opportunity had to be submitted to the shareholders because diversity was not a “mundane” matter and it involved a “substantial policy” given the importance of a diverse workforce for a company’s competitiveness. Using the same reasoning, the SEC ruled in 1990 that AT&T was required to submit for a shareholder vote a resolution by a white supremacist group that asked AT&T to abandon its entire affirmative action program.<sup>52</sup> The SEC’s 1992 Cracker Barrel ruling meant that shareholders had no right to vote on any resolution dealing with a company’s employment policies, even when some shareholders believed that the policy, like Cracker Barrel’s policy decision not to hire gays or lesbians, was morally objectionable. If shareholders are the owners of a company, do they not have the right to force a vote and make their voice heard? Some people consider the right to vote on important issues a matter of shareholder democracy.

Supporters of the SEC’s Cracker Barrel ruling note that the shareholders have already elected the board of directors, which, in turn, selects the management team. If shareholders disapprove of the way in which the board and management are running a company, then they should attempt to vote them out. In the meantime, shareholders should leave the top executives free to run a company as they see fit and not interfere in day-to-day operations. Indeed, boards of directors typically involve themselves only in the selection of management and the overall strategy of the company and leave all other matters to the management team. However, directors are usually nominated by a committee of the board, and federal and state law does not, in general, give shareholders any right to nominate candidates of their own.<sup>53</sup> Usually, the

shareholders' only power is to withhold votes from a slate presented to them by the current board. In response to demands for greater shareholder democracy, the SEC announced plans in 2003 to examine whether shareholders should have a greater voice in the nomination of directors.<sup>54</sup> By the end of 2007, though, no changes had been made.

## Limiting Shareholder Voice

Shareholder activists tend to be state and union pension funds, religious organizations, and other social action groups that use the shareholder resolution process to advance their own causes. For example, in 1971, the Episcopal Church proposed a resolution that General Motors cease operations in South Africa in protest against the country's racial apartheid policy. During the Vietnam War, shareholder resolutions were proposed by antiwar activists to force Dow Chemical Company to stop manufacturing napalm. Typically, shareholder resolutions included in proxy materials are defeated by large margins. However, the aim of activist shareholders is usually not to affect corporate behavior but to effect larger social change by increasing public awareness of issues. Even when such activism is socially beneficial, though, critics charge that shareholder resolutions are a distraction for corporations and that social change ought to be brought about through the political process, not by means of shareholder resolutions. Some argue that people who are citizens in a democratic state do not need shareholder democracy.

In 1998, the SEC reversed the Cracker Barrel ruling and reverted to a case-by-case application of the two-part 1976 test that asked whether the resolution involved "business matters mundane in nature" and did not involve "any substantial policy or other considerations." In announcing the change, the SEC observed that since the Cracker Barrel ruling, "the relative importance of certain social issues related to employment has re-emerged as a consistent topic of widespread public debate."<sup>55</sup> As a result of this reversal, the power of shareholders to vote on matters that concern them was increased.

### SHARED WRITING: SHAREHOLDER RIGHTS AT CRACKER BARREL

Explain whether shareholders should have a right to vote directly on a company's employment policies. Would this ability open the door to shareholders "micro-managing" daily operations, or is it justifiable given how such policies shape the public's perception of the company (and thus influence its profitability)?

Review and comment on at least two classmates' responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

## Case: The Sale of Trans Union

Promptly at noon on Saturday, September 20, 1980, nine members of the board of directors of Trans Union Corporation gathered for a hastily called special meeting.<sup>56</sup> None of the five outside directors had been informed of the meeting's purpose or had been provided in advance with any materials to study. Only one hour earlier did any of the top executives learn of the plan to be proposed to the board by the chairman and CEO, Jerome W. Van Gorkom. The plan was to sell the company for a price of \$688 million to the Marmon Group, headed by Jay A. Pritzker, a prominent takeover specialist and chairman of the Hyatt hotel chain.

## Planning the Sale

Trans Union Corporation was a publicly traded, diversified holding company, located on LaSalle Street in Chicago. Founded in 1968 out of the Union Tank Car Company, Trans Union was engaged primarily in the business of leasing railroad cars. Although the company was doing well, it could not match the lower rates of its competitors in the railroad-car leasing business due, in large part, to its inability to benefit from an investment tax credit. Because the credit was offered as an offset on the company's taxable income, Trans Union could not realize the full benefit since deductions for depreciation reduced its taxable income below the full amount of the credit. Lobbying efforts in Congress for a change in the tax code to permit the receipt of the credit in cash had proved fruitless. Among the other solutions to this problem examined by company executives were a leveraged buyout by management and a sale to a larger company with more taxable income.

On his own, without consulting the board or any other executives except one, Van Gorkom arranged to meet with Pritzker at the latter's home on Saturday, September 13. The two men had been acquainted socially for more than 10 years and had worked together on the Chicago School Finance Authority to rescue the city school system from a financial crisis. Rather than merely seeking to discern Pritzker's interest, Van Gorkom presented him with a detailed proposal based on a \$55-per-share price, which represented a premium of 48 percent over the current price and 62 percent over the average of the high and low prices during 1980. Van Gorkom explained how Pritzker could finance the deal so as to realize the extra value reflected in the premium. Pritzker was interested in the deal, and after several more meetings over the next few days to settle certain details, he announced that he was ready to make a \$55-per-share all-cash offer for the company. However, Pritzker insisted that the deal had to be completed by Sunday of that week, September 21.

At an 11:00 A.M. meeting of top executives on Saturday morning, September 20, the reaction was decidedly

negative. Van Gorkom gave an oral account of the proposed agreement to his management team with no supporting documentation. Several of the executives questioned how the \$55 price had been determined and whether it was too low. Objections were also made to several conditions that Pritzker had inserted that would discourage any rival bidders for the company. Some executives also expressed concern about the adverse tax consequences of an all-cash buyout for certain shareholders. The executives realized, though, that the decision was not theirs to make: The board of directors had the responsibility of deciding whether to approve the proposed agreement and submit it to the shareholders for a vote.

## Board Consideration

During the two-hour special board meeting on September 20, immediately following the session with company executives, Van Gorkom gave a 20-minute oral presentation of the proposed agreement, again without providing written copies. He did not offer any analysis to support the \$55-per-share price. He did not claim that this was the highest price that could be obtained but only that it was a fair price, which the shareholders should be allowed to accept or reject. It is common in such situations to seek a fairness opinion from an investment advisory firm to attest that the price placed on a company for sale is fair, but no such opinion had been sought in this case. Van Gorkom did not mention that he had proposed the \$55 price to Pritzker rather than receiving an offer at this price from him. He defended the price on the ground that once the Pritzker offer was announced, other bidders could come forth, thus allowing the market to determine the highest price that could be obtained.

The chief financial officer of Trans Union, who had not been aware of the proposed agreement until that morning, told the board that he had not attempted to determine the company's value. The studies he had done were aimed, rather, at analyzing the feasibility of a management buyout at different share price levels in the \$50 to \$60 range. He explained that this methodology would not yield a valid price for the company but would produce only a reasonable approximation. He told the board that, in his opinion, \$55 was "in the range of a fair price" but "at the beginning of the range." An outside lawyer, who had been retained by Van Gorkom to advise the company on the sale, told the board, correctly, that a fairness opinion was not legally required and that they might be sued by shareholders if they did not allow the shareholders to vote on the offer.

At the end of two hours, the directors voted to accept the proposed agreement, without having read it. The board members later claimed that they had attached two conditions to the agreement that reserved the right to accept a better offer if one were made before the deal was

completed, and that committed the company to provide any potential bidder with confidential financial information. However, these conditions were not recorded in the meeting minutes nor incorporated into the final agreement. Moreover, the board did not reserve the important right to actively solicit other bids.

That evening was the opening night of the Chicago Lyric Opera season. Following tradition, Van Gorkom and his wife hosted a formal pre-opera gala party on the 25th floor penthouse of the Trans Union Building for a large number of Chicago's elite, including the Pritzkers. During the celebration, Van Gorkom and Pritzker, attired in tuxedos, slipped down to the floor below where a team of lawyers was putting the final touches on the sale documents. Before leaving for the opera—a production of Modest Moussorgsky's "Boris Godunov"—they signed the agreement to sell Trans Union to Pritzker's Marmon Group. This agreement, which still had to be presented for a shareholder vote, was not yet complete, though. Pritzker was forced to make some concessions to keep key Trans Union executives from leaving, but he also added some provisions that further limited the board's ability to obtain a better offer or withdraw from the deal. Van Gorkom reconvened the board for a meeting on October 8. However, the final agreement, executed on October 10, contained provisions that differed from what Van Gorkom had told the directors. No member of the board had read the final agreement, and Van Gorkom himself apparently failed to appreciate the implications of some of the changes.

## Shareholder Challenge

On January 26, 1981, the board met and voted to proceed with the sale. The shareholders approved the sale with 69.9 percent in favor, 7.25 percent against, and 22.8 percent not voting. Before the vote, a group of shareholders brought a class-action suit challenging the sale. These shareholders sought to hold the individual board members personally liable for failing to fulfill their fiduciary duty in approving the sale, citing specifically the duty of candor to disclose fully all relevant information and a duty of care to inform themselves fully before taking action. The monetary award sought was the difference between the sale price of \$55 per share and the true value of the company.

Although directors and officers of publicly held corporations have a fiduciary duty to shareholders, they also have the benefit of the business judgment rule, which protects them from shareholder suits alleging a breach of fiduciary duty as long as they act reasonably and there is no evidence of negligence, bad faith, fraud, or self-dealing. The purpose of the business judgment rule is to insulate corporate decision making from second-guessing by the courts and to avoid unnecessary personal risk for individual officers and directors, which might make them unduly



cautious. According to this rationale, shareholder interests are better served if the fiduciary duty of corporate actors is not excessively stringent but is tempered by the business judgment rule.

The Delaware Supreme Court reversed a lower court ruling and found that Van Gorkom and the other directors guilty of a breach of their fiduciary duty. The opinion of the judge writing for the majority stated the following:

Under the business judgment rule there is no protection for directors who have made “an unintelligent or unadvised judgment.” A director’s duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.<sup>57</sup>

This decision provoked a strong, immediate reaction, with one critic calling it “surely one of the worst decisions in the history of corporate law.”<sup>58</sup> One dissenting judge in the case opined that while the board may not have read the material, they were experienced men of business who knew the company thoroughly, had confidence in its top executives, and understood the need, in this case, for quick action. The five outside directors on the board were very knowledgeable about mergers and acquisitions and had a thorough grasp of Trans Union’s financial condition and strategic direction. Four of them were CEOs of other companies, and the fifth was a former dean of the University of Chicago business school. While \$55 per share may not have

been the highest amount obtainable, it was still a fair price. Other critics have stressed the cost involved in gathering and processing information compared with the benefit for shareholders and the need to rely on the expert opinion of company management and professional advisers.

In response to this negative reaction, the Delaware General Assembly passed legislation that allowed corporations chartered in the state to protect directors and officers from shareholder suits for failure to fulfill the standard of fiduciary duty employed in the Trans Union case. The effect of this legislation was to permit corporations, with shareholder approval, to bypass the decision in the Trans Union case, and, subsequently, virtually all large Delaware-incorporated companies have done this. As a result, successful suits for breach of fiduciary duty today can be brought only for egregious cases of fraud, bad faith, or self-dealing and not merely for the kind of conduct exhibited by the directors of Trans Union Corporation.

#### SHARED WRITING: THE SALE OF TRANS UNION

Explain whether or not Trans Union’s board of directors failed in their fiduciary duty to shareholders. If all board members were held to the standard set by the Delaware Supreme Court, what positive and negative effects might this high standard have on their performance as directors?

Review and comment on at least two classmates’ responses.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

0 characters | 140 minimum

#### Chapter 13 Quiz: Governance, Accountability, and Compliance

## Chapter 14

# International Business Ethics



## Learning Objectives

- 14.1** Categorize the various ethical problems that multinational companies may face in their foreign operations, especially while conducting business in less-developed countries
- 14.2** Explain how the moral concepts of rights, welfare, and justice offer guidelines for conducting international business and the role of global civil society in developing and enforcing these guidelines
- 14.3** Describe the ethical issues in determining wages and standards for working conditions in international business, and factors that multinational corporations and foreign contractors should consider to improve on those set by market mechanisms
- 14.4** Evaluate the various forms of bribery and factors that foster them, the ethical problems with bribery, and the diverse means and strategies for combating bribery
- 14.5** Relate the challenges multinational companies face in dealing with repressive governments, and how a strategy of constructive engagement can be applied to operations in countries with a record of human rights abuses

### Case: Mattel's Toy Woes

In 2007, consumers everywhere were alarmed by reports of hazardous Chinese products, ranging from tainted pet food and toothpaste to defective automobile tires.<sup>1</sup> None of these scares, though, matched the concern in the United States over lead paint on toys manufactured for Mattel in China, which led to two highly publicized recalls in August of that year. On August 2, 2007, Mattel jointly announced, with the Consumer Products Safety Commission, a voluntary recall of 1.5 million Chinese-made toys containing impermissible amounts of lead. Shortly before this announcement, the company became aware of lead contamination in another line of toys produced by a different vendor, which became the subject of another voluntary recall on August 14. These two recalls undermined the confidence of consumers not only in all products made in China but also in the ability of a company, even one as diligent as Mattel, to effectively enforce its stringent standards of safety in an extended global supply chain.

#### The Recalls

Mattel, Inc., with headquarters in El Segundo, California, was the world's largest toy company by revenue. It grew

from its modest founding in 1945 to a global giant that by 2007 produced 800 million items a year under more than 100 registered brands, including Fisher-Price toys, Hot Wheels and Matchbox cars, and Barbie and American Girl dolls. Mattel had long experience manufacturing in Asia, with the first Barbie dolls produced in Japan in 1959. Like other toy companies, Mattel sought low-wage labor in developing countries, closing its last U.S. plant in 2002; but, unlike its competitors, Mattel recognized the perils of outsourcing production to independent factories.

The needs to ensure product quality and prevent counterfeiting led Mattel to own and operate its own plants abroad rather than outsourcing production to contract factories. Of Mattel's 10 company-owned foreign facilities, 5 were in China. By 2007, 65 percent of Mattel products were made in China, although one-half of its products worldwide were made in company-owned factories. These Mattel factories manufactured the company's most valuable core products, which were vulnerable to counterfeiting and other problems that could affect brand image. The other half, which consisted of less valuable and less vulnerable, noncore products, was manufactured by independent contract factories, 37 of which Mattel dealt directly with in China. However, these 37 factories used subcontractors, which, in turn, had their own subcontractors, so that in 2007, Mattel toy production in China involved an estimated 3,000 companies.

The August 2 recall affected products manufactured by Lee Der Industrial, located in Foshan, China, in Guangdong province, where most toy production was clustered. Mattel had sourced from Lee Der for 15 years, during which time the Chinese vendor had generally observed the stringent guidelines that Mattel had long imposed to ensure safety. Lead paint is a well-recognized hazard due to the serious neurological effects of lead, especially on the bodies of young children, who are apt to ingest it from chewing on toys. Although generally banned, lead paint is still in common use because it has a brighter color, is easier to apply to hard surfaces, and, most important, is 30 percent cheaper than nonlead paint. Mattel vendors were permitted to source paint from only eight approved suppliers, which were required to test paint batches to ensure that they met standards and to link each batch with the certificates of compliance. The vendor was responsible for checking the certification of each batch, and Mattel checked the records and conducted its own tests at least every three months. Once a vendor was approved, it was prohibited from moving production to any new facility without notifying Mattel.

Lee Der, which manufactured 83 different products for Mattel, used three of the approved paint suppliers. One of these suppliers apparently ran short of yellow paint and found on the Internet a company that provided 330 pounds of yellow pigment for a cost of \$1,250, accompanied by falsified documents that the supplier failed to detect. Later attempts to locate this company proved futile, and the individuals involved have disappeared. Although Lee Der had equipment for conducting lead tests, it was not used for the newly supplied paint. The lead paint on some Mattel products manufactured by Lee Der was discovered by a French importer, which immediately notified Mattel headquarters. Mattel executives also received a report of lead on some toys from a mother in the United States using a home test kit. At first, Mattel thought that Lee Der had corrected the problem of lead paint, but the company soon realized that it faced a more serious systemic problem and quickly ceased accepting deliveries from the troubled Chinese vendor.

The August 14 recall involved 460,000 units of the Sarge car in the Pixar line from another vendor, Early Light Industrial Company, which Mattel had used satisfactorily for 20 years. In this case, Early Light had subcontracted the painting of the olive-green roof of the car to another company but provided the paint from an authorized supplier. However, the subcontractor either ran out of paint or else sold the paint and bought a cheaper substitute from an unapproved supplier. Contrary to Mattel rules, the use of the subcontractor had not been disclosed. Following an extensive testing of other products, which revealed more cases of lead paint on toys, Mattel stopped all production in China until the source of the problem could be discovered and corrected, and the company instituted another recall of a few products on September 4, 2007.

Lead paint was not the only hazard known to Mattel at this time. Because magnets in some toys could be dislodged and ingested by children, resulting in intestinal blockage and rupture when the magnets joined together, Mattel also instituted a recall of 17.4 million units of some popular magnet-based toys, mostly Polly Pocket, Batman, and Doggie Daycare play sets.

## Assigning Blame

The initial reaction of Mattel was to blame the vendors for violations of long-standing rules that the company had carefully developed and implemented. With decades of experience in Asia, Mattel recognized the risks from long supply chains for materials, and so it insisted that its vendors follow a list of detailed rules designed to ensure product quality and safety. One observer commented, "Mattel was in China before China was cool, and they learned to do business there in a good way. They understood the importance of protecting their brand, and they invested."<sup>2</sup>

Mattel's system involved close monitoring but still depended, to some extent, on the vendors' voluntary compliance, which was subject to failure. Robert A. Eckert, the Mattel CEO, commented that "we wouldn't have faced this problem if our suppliers followed the rules." Another executive explained, "I think it's the fault of the vendor who didn't follow the procedures we've been living with for a long time."<sup>3</sup> In addition to the recalls, Mattel stepped up the enforcement of its rules with a three-stage safety check that involved testing every batch of paint by the vendor, testing samples of finished products by Mattel, and conducting random, unannounced inspections of vendors. Mattel also tightened the rules requiring that vendors notify the company of the use of any subcontractors before engaging them and imposed a new rule that prohibited subcontractors from outsourcing further.

### Whom did critics blame?

Critics placed some of the blame on Mattel and the competitive environment in which the company operates. The toy industry depends heavily on fads in which a few novel items prove extraordinarily popular but sell for very short periods. It is essential that companies constantly innovate and rush new products into production quickly in the right quantities and at the right times (generally in the last two quarters of the year when the vast majority of toys are sold). Above all else, it was important to find the right price point for marginal consumers. Mattel had developed a very rigorous, detailed bidding process that forced vendors to compete not only on quality and delivery but also on price. Although retail customers are price sensitive in buying toys, even more pressure for low prices comes from the giant retailers, such as Walmart, Target, and Toys "R" Us, which together account for 45 percent of Mattel sales.

In China, the rising costs of labor and materials and the rising value of the currency, the *yuan*, put tremendous pressure on vendors to cut corners wherever possible. One critic noted, "There was a lot of scapegoating China, but . . . this was caused by a system that is designed to push down costs and speed up delivery. There are root causes and Mattel is behind those."<sup>4</sup> Although

scapegoating China took some pressure off Mattel and made it look like a victim rather than a perpetrator, other critics argued that the vast majority of recalls were due not to manufacturing faults, such as lead paint, but to design flaws that originated with the toy companies themselves. One study found that over the past 20 years, 76 percent of all recalls of toys were due to design problems, such as the loose magnets in Mattel's magnet-based products, and only 10 percent were caused by faulty manufacturing.<sup>5</sup>

Mattel's efforts to blame vendors backfired. Chinese government officials and industry leaders feared that the public image being conveyed by Mattel threatened the export basis of the Chinese economy. The owner of the Lee Der factory, Zhang Shuhong, aged 52, committed suicide in his empty factory after Mattel ceased accepting deliveries. Mr. Zhang had a reputation for treating workers well, paying wages on time, and not requiring mandatory overtime. He had devoted his life to the company and was preparing, at the time, to open a newly completed \$5 million plant. His last act was to order that the machinery be sold so the workers could be paid.

Mattel has also been criticized for not treating consumer safety with the same kind of care that the company has devoted to worker protection. Before Christmas 1999, the NBC news program *Dateline* broadcast a story about Mattel's alleged use of underage workers in Indonesia, and the magazine *U.S. News and World Report* featured a cover story with the headline "Sweatshop Christmas." At the time, workers, mostly young women on three- to four-year contracts, worked 10-hour days, six days a week for around \$120 to \$175 a month; they generally lived in crowded on-site dormitories, had their meals deducted from their pay, and were often forced into working overtime.

## How do you think Mattel responded to these issues?

### Mattel's Response

In response to this unwelcome publicity and to intense pressure from the "anti-sweatshop" movement, Mattel developed a model program that included a set of Global Manufacturing Principles. The company also submitted to monitoring by an independent organization, the International Center for Corporate Accountability (ICCA), which was willing to be engaged only on the condition that its reports be made public. In the view of one observer, Mattel "has gone further than any other company to be a good corporate citizen with regard to its Chinese operations."<sup>6</sup> Although Mattel aggressively addressed problems in the treatment of workers, it did not adopt the same auditing and monitoring processes for product safety. According to the head of ICCA, "The code was designed to protect Chinese workers from being exploited. Nobody was thinking about unsafe products. They were thinking about cheap products."<sup>7</sup>

To allay Chinese concerns about the recalls, Mattel met with government officials and issued a press release clarifying that the recall of toys with magnets was a design flaw for which Mattel took full responsibility, and the press release also admitted that some of the toys that had been withdrawn from the market had low levels of lead that did not exceed the standards of the United States or any other country. This press release was perceived by some as an apology that exonerated the Chinese vendors. Senator Charles Schumer complained, "It's like a bank robber apologizing to his accomplice instead of the person who was robbed. . . . They're playing politics in China rather than doing what matters."<sup>8</sup> Mattel responded that its statement had been "mischaracterized" and replied, "Since Mattel toys are sold the world over, Mattel apologized to the Chinese today just as it has wherever its toys are sold."<sup>9</sup>

## Points to Consider . . .

Increasingly, business is being conducted across national boundaries. As large multinational corporations (MNCs) that have long operated in other countries are expanding their international presence, they are being joined by smaller domestic firms going abroad for the first time. Intense competition and profitable opportunities are forcing companies worldwide to enter the global marketplace, whether they are ready or not.

This development presents a host of ethical problems that managers are often unprepared to address. Some of these problems arise from the diversity of business standards around the world and especially from the lower standards that generally prevail in developing countries. Companies are able to pay wages and impose working conditions that are shockingly low by U.S. standards, and yet they usually operate well above the standards of local firms. With extended supply chains, companies, such as

Mattel, find it difficult to ensure the integrity of their products. Environmental standards in developing countries are also invariably lower than those of developed countries. MNCs may also operate in countries with repressive governments that routinely violate human rights and in so doing become complicit in their barbarous deeds. This is especially true in extractive industries, such as oil and minerals, since companies must go where the resources are located. And in countries with pervasive corruption, it may be advantageous, and even necessary, to conduct business by paying bribes, as discussed in Case: Walmart in Mexico.

Additional problems result from the power of multinational corporations to affect the development in emerging economies. MNCs often exploit the cheap labor, lower standards, and natural resources of developing countries without making commensurate investments that would advance local economic development. These problems are exacerbated when companies successfully avoid onerous

regulations and their fair share of taxes. Even though developing countries invariably benefit to some extent from the activities of MNCs, the distribution of the gains is usually unequal. Critics ask whether it is fair for corporations from developed countries to return so little to the less-developed parts of the world from which they derive so much.

Operations in foreign countries also raise questions about the proper role of corporations in political affairs. Most multinationals consider themselves to be guests in host countries and refrain from influencing local governments. However, Google was widely criticized for enabling the Chinese government to censor the Internet and thereby maintain its dictatorial control. MNCs have an opportunity to play a constructive role in countries making the transition from a socialist, planned economy to a free market. The high levels of repression and corruption in some of these countries, though, present special challenges.

This chapter begins with the problem of determining the appropriate ethical standards for operating globally, especially when multinational companies conduct business in less-developed countries. Applying home country standards in all parts of the world is generally not morally required, but adopting host country standards for wages, working conditions, and other matters may be morally impermissible. The first question addressed is, what principles can guide us in finding a justifiable middle ground? These principles are then applied to the issue of wages and working conditions, especially in factories with which MNCs contract for the production of their goods. Although bribery is universally recognized as wrong, it, too, is a practice that is viewed differently around the world and may sometimes be an unavoidable condition of operating in some countries. Accordingly, a section is devoted to understanding the critical problem of foreign bribery. Finally, this chapter examines the challenges of dealing with repressive governments that engage in massive violations of human rights.

## 14.1: Different Standards

### 14.1 Categorize the various ethical problems that multinational companies may face in their foreign operations, especially while conducting business in less-developed countries

The main charge against multinational corporations is that they adopt a double standard, doing in less-developed countries what would be regarded as wrong if done in the developed world. However, many criticized practices are legal in the countries in question and may not be considered unethical by local standards. Should MNCs be bound by the prevailing morality of the home country and, in the case of American corporations, act everywhere as they do

in the United States? Should they follow the practices of the host country and adopt the adage “When in Rome, do as the Romans do”? Or are there special ethical standards that apply when business is conducted across national boundaries? If so, what are these appropriate standards for international business?

Unfortunately, there are no easy answers to these questions. In some cases, the standards contained in American law and morality ought to be observed beyond our borders; in other cases, there is no moral obligation to do so. Similarly, it is morally permissible for managers of MNCs to follow local practice and “do as the Romans do” in some situations but not others. Even if there are special ethical standards for international business, these cannot be applied without taking into account differences in cultures and value systems, the levels of economic development, and the social, political, and legal structures of the foreign countries in which MNCs operate.

How should multinational corporations conduct business in countries with different cultures and value systems?

In answering this question, there are two extremes.

- The absolutist position is that business ought to be conducted in the same way the world over with no double standards. In particular, U.S. corporations ought to observe a single code of conduct in their dealings everywhere. This view might be expressed as, “**When in Rome or anywhere else, do as you would at home.**”<sup>10</sup>
- The opposite extreme is relativism, which may be expressed in the familiar adage, “**When in Rome, do as the Romans do.**” That is, the only guide for business conduct abroad is what is legally and morally accepted in any given country where a company operates.

Neither of these positions can be adopted without exception. The generally high level of conduct that follows from “When in Rome, do as you would at home” is not morally required of MNCs in all instances, and they should not be faulted for every departure from home country standards in doing business abroad. However, “When in Rome, do as the Romans do” is not wholly justified either. The mere fact that a country permits bribery, unsafe working conditions, exploitive wages, and violations of human rights does not mean that these practices are morally acceptable, even in that country. Even what is legal in a country may be difficult to determine, but ascertaining the accepted ethical standards is especially problematic. Bribery, for example, is almost universally condemned, but the people in some countries may consider it to be less offensive than those elsewhere, and it may be tolerated (but not approved) as an unavoidable practice. In such situations, what *is* the local standard with regard to bribery? The debates over absolutism and relativism—two of the

positions on the “what to do in Rome” question—revolve around four important points:

- relevant differences between countries,
- the influence of different outlooks,
- the right to decide, and
- business necessity.

### 14.1.1: Relevant Differences

Some conditions in other countries, especially those in less-developed parts of the world, are different in morally relevant ways. As a result, different standards may be morally permitted, indeed required.

If Rome is a significantly different place, then standards that are appropriate at home do not necessarily apply there.

**First, practices may have different impacts under different conditions, so that what is unethical in one country may not be so in another.** For example, pharmaceutical companies have been criticized for adopting a double standard in promoting drugs in less-developed countries with more indications for their use and fewer warnings about side effects. Although such practices may be designed solely to promote sales—in which case, they may be considered unethical—some drugs may be medically appropriate in a poor country for a wider range of medical conditions, and hence may be ethically indicated for them.

**Example:** With regard to one powerful but dangerous antibiotic, which is prescribed in the United States only for very serious infections, doctors in Bolivia claim that this limited use is a luxury that Americans can afford because of generally better health. “Here,” they say, “the people’s general health is so poor that one must make an all out attack on illness.”<sup>11</sup> Thus, an antibiotic that should be marketed in the United States with one set of indications might be justifiably sold abroad with a more extensive list if, indeed, the drug’s benefits vary according to conditions.

**Second, the relative level of economic development must be taken into account in determining the appropriate standards for different countries.** Thomas Donaldson suggests that in evaluating a standard in a less-developed country, we should ask what standard would be adopted in our home country if it were at a comparable level of economic development.<sup>12</sup> Health and safety standards in the developed world are very stringent, reflecting greater affluence and a greater ability and willingness to pay for more safety. The standards of these countries are not always appropriate in poorer, less-developed countries with fewer resources and more pressing needs, and lower standards for health and safety were prevalent in the

United States when the country was less affluent and concerned with more pressing matters.

**Example:** The accident at the Union Carbide plant in Bhopal, India, in 1984, which exposed hundreds of thousands of poor local residents to 40 tons of highly toxic methyl isocyanate, resulted from some safety lapses that would be morally wrong in any country. Some low levels of safety may be regarded as violations of basic human rights anywhere. However, the design and operation of the Bhopal plant, which produced a much needed pesticide, Sevin, also resulted from trade-offs that were favored at the time by the Indian government to promote agricultural development. The plant was located in populous Madhya Pradesh state to increase employment there, manual rather than automatic gauges and valves were installed to create more jobs and cut costs, and a less-safe method for producing Sevin in which methyl isocyanate was an intermediate step was used to make the pesticide more affordable to poor farmers.<sup>13</sup> Although these trade-offs had tragic consequences, some of them might be considered reasonable given the urgent need of India for a cheap pesticide to grow sufficient food for its burgeoning population. Such trade-offs would not be made in the wealthier United States at the present time, but this country made different trade-offs between safety and other values at earlier stages of its economic development.

### 14.1.2: Variety of Outlooks

The absolutist position assumes that one country’s standards are correct and that they should be imposed on people elsewhere, perhaps in conflict with their own moral values and principles. Acting on these assumptions ignores the wide variety of ethical outlooks in the world. Although some bedrock conceptions of right and wrong exist among people everywhere, many variations occur due to cultural, historical, political, and economic factors.

These differences are important, first, because they may affect the *meaning* of acts performed. For example, lavish gifts that would be considered bribes or kickbacks in the United States are an accepted and expected part of business in Japan and some other Asian countries. This difference in perception is due, in part, to the role that gift giving plays in building relationships, which are more critical in Asian business. Thus, giving gifts in Japan and China is usually understood not as an attempt to improperly influence a person’s judgment but rather as a means of cementing a legitimate relationship.<sup>14</sup> Similarly, whistleblowing, which is generally viewed favorably in the United States as a moral protest, is regarded unfavorably in Japan and China as an act of disloyalty. In both cases, there are differences among people in various countries about the

very meaning of what a person has done in giving a gift or blowing the whistle.

The impact of historical, political, and economic differences can be seen in Russian views of business ethics. The collapse of communism and the chaotic development of free markets in the former Soviet Union have created great uncertainty about ethical business behavior.<sup>15</sup> Although Russians and Americans agree on many matters, such as the importance of keeping one's word, paying debts, competing fairly, and avoiding extortion, they still differ in their ethical assessment of certain other matters.

#### Examples:

- Less stigma is attached in Russia to making payments for favors (*blat*), falsifying information, and coordinating prices because of the prevalence of these practices in the previous planned economy and the lack of efficient markets that require impersonal, arm's-length exchange, truthful information, and accurate prices. The lack of a workable legal system forces Russian managers to ignore senseless and contradictory regulations. Unfortunately, a certain amount of lawlessness is necessary for operating in the current business environment.
- On the other hand, Russia's socialist tradition leads them to criticize America's tolerance for exorbitant pay differentials and massive layoffs.
- As in Japan, whistle-blowing is viewed with suspicion, but for a different reason: It reminds Russians of the informer ethos that existed during the communist era.

In addition to historical, political, and economic differences, culture can deeply influence not only basic values but also the nature of a people's moral thinking. The most striking feature of East Asian ethics, which is based on the teachings of Confucius or Confucianism, is the central role of long-term relationships. These rest on a high level of trust and reciprocity among all the parties and require careful attention to each party's interests so as to maintain harmony. In a society built on relationships, ethical obligations depend not on universal moral principles that characterize the western Judeo-Christian heritage but on the duties that attend specific roles and relationships. Accordingly, norms in such a society tend to be relative or situational rather than absolute and universal.<sup>16</sup> Instead of known rules that are applied equally to all, moral decisions are made on a case-by-case basis with attention to specifics.

An example of a Confucian-based ethical difference is the Chinese practice of *guanxi*, in which business depends on a web of long-term reciprocal relationships. Foreigners complain that because of *guanxi*, they cannot do business in China without first building the necessary long-term relationships, which may involve payments that appear to

be bribes. Relationships are often the result of school and work ties that arise from decades of interactions and mutually beneficial exchanges that cannot be quickly duplicated by outsiders, who consequently feel that they are victims of cronyism. On the other hand, *guanxi* exists not only because of the Confucian emphasis on relationships but also because of the need for trust among business partners in a society without legally enforceable contracts and efficient, transparent markets, which are taken for granted in Western Europe and the United States. Thus, whether the practice of *guanxi* is ethical depends not only on the ethical value of relationships but also on their usefulness in overcoming a lack of trust in a society that has not yet developed reliable laws and markets.

### 14.1.3: Right to Decide

The absolutist position denies the right of the people who are affected to decide on important matters of business conduct. The primary responsibility for setting standards should rest on the government and the people of the country in which business is being conducted. The argument that the people affected have a right to decide is not a form of ethical relativism. The fact that people approve of a certain practice does not make it right. The argument is rather an expression of respect for the right of people to govern their own affairs, rightly or wrongly. Imposing the standards of a developed country on developing countries is criticized by some as a form of "ethical imperialism."

The process of avoiding "ethical imperialism" and allowing the people affected to decide must be approached cautiously. A respect for the right of people to set their own standards does not automatically justify corporations in inflicting grave harm on innocent people, for example, or violating basic human rights. Furthermore, it may be difficult to determine what people have decided. Some countries lack the capacity to regulate effectively the activities of MNCs within their own borders. The governments of developing countries are, in many instances, no less committed than those in the United States and Europe to protecting their people against harm, but they do not always have the resources—the money, personnel, and institutions—to accomplish the task.

Some countries with the capacity to regulate multinationals lack the necessary will. MNCs, through the exercise of economic power, including bribery, are able to influence regulatory measures. The governments of developing countries are also careful not to offend the developed countries on which they depend for aid. Furthermore, the absence of laws against unethical business practices is sometimes part of a pattern of oppression by local elites that exists within the country itself, so that MNCs are taking advantage of the immorality of others when they follow the law of countries with corrupt governments.

Consequently, we need to ask whether a standard in a host country, if it is lower than that at home, truly represents the considered judgment of the people in question.

Does the standard reflect the decision that people would make if they had the capacity to protect their own interests effectively?

A genuine respect for the right of people to determine which standards to apply in their own country requires a careful and sympathetic consideration of what people would do under certain hypothetical conditions rather than what is actually expressed in the law, conventional morality, and commonly accepted practices.

#### 14.1.4: Business Necessity

Some practices may be justified where local conditions require that corporations engage in them as a necessary condition for doing business. This point may be expressed by saying, “We don’t necessarily agree with the Romans, but find it necessary to do things their way.” American firms with contracts for projects in the Middle East, for example, have complied in many instances with requests not to station women and Jewish employees in those countries. Although discrimination of this kind is morally repugnant, it is (arguably) morally permissible when the alternative is to risk losing business in the Muslim world.

A more complicated case was posed by the boycott of Israel, which was begun by the countries of the Arab League in 1945. In order to avoid blacklisting that would bar them from doing business with participating Arab League countries, many prominent U.S. companies cooperated by avoiding investment in Israel. Other firms, however, refused to cooperate with the boycott for ethical reasons. (Congress addressed this issue in 1977 by amending the Export Administration Act to prohibit American corporations from cooperating with the Arab League boycott against Israel.)

As with the other arguments, “There is no other way of doing business” cannot be accepted without some qualifications. The alternative is seldom to cease doing business; rather, the claim that a practice is “necessary” often means merely that it is the easiest or most convenient way of doing business.

##### Examples:

- The embargo against Israel greatly complicated the problem of doing business in the Middle East, but some companies, including RCA, Coca-Cola, Hertz, and John Deere, were able to avoid cooperating with the boycott and still have business relationships in Arab countries, although their success was due, in part, to loopholes and inconsistencies in the enforcement process.<sup>17</sup>

- Similarly, during the period of apartheid in South Africa, some American companies defied the government and integrated their workforces.

There are some situations, however, in which a company is morally obligated to withdraw if there is no other way to do business. Some companies have refused to do business in certain countries because they believe that involvement in an immoral system cannot be justified.

#### WRITING PROMPT

##### What to Do in Rome

Consider the two “when in Rome” sayings that have been applied to conducting business abroad: “when in Rome, do as you would at home” and “when in Rome, do as the Romans do.” Write your own version of these sayings to describe how MNCs generally should conduct business in countries with different cultures and value systems, taking into account the issues discussed in this section. Explain your view.

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 14.2: Guidelines for Multinationals

### 14.2 Explain how the moral concepts of rights, welfare, and justice offer guidelines for conducting international business and the role of global civil society in developing and enforcing these guidelines

If neither home country nor host country standards provide complete guidance, what rules or principles should multinational corporations follow? Just as important is the question of rule-making power or authority. That is, who should rightfully participate in the rule-making process for the conduct of multinational corporations? In recent decades, both rule-making power and authority have shifted from national governments to what has been termed “global civil society.”<sup>18</sup>

This section considers both questions:

- First, the basis for guidelines for conduct in international business
- Second, the role of global civil society in developing and enforcing these guidelines

Guidelines for the conduct of multinational corporations are based on three main considerations: rights, welfare, and justice. All of these are relevant moral concepts; the challenge is determining exactly how they apply to international business. These three concepts are further incorporated into a number of international codes for global business practice.



### 14.2.1: Rights

Thomas Donaldson has proposed that corporations have an obligation to respect certain rights, namely those that ought to be recognized as fundamental international rights.<sup>19</sup> MNCs are not obligated to extend all the rights of U.S. citizens to people everywhere in the world, but there are certain basic rights that no person or institution, including a corporation, is morally permitted to violate. Fundamental international rights are roughly the same as natural or human rights, and some of these are given explicit recognition in such documents as the United Nations Universal Declaration of Human Rights, the International Covenant on Social, Economic, and Cultural Rights, and the International Covenant on Civil and Political Rights.

**SPECIFYING RIGHTS** The main problem with a principle to respect fundamental international rights (or fundamental rights, for short) is specifying the rights in question. Even undeniable human rights that create an obligation for some person or institution, such as the government of a country, are not always relevant to a multinational corporation. Moreover, observing a right ranges from merely not depriving people of some protection to ensuring the fulfillment of a right. For example, everyone has a right to subsistence, but a corporation may be under no obligation to feed the hungry in a country where it operates, especially if doing so has no relation to its business activity. It has an obligation, however, not to contribute directly to starvation by, say, destroying farmland. In general, Donaldson claims, a corporation is morally bound only by those minimal duties such that “the persistent failure to observe [them] would deprive the corporation of its moral right to exist” and not by maximal duties whose fulfillment would be “praiseworthy but not absolutely mandatory.”<sup>20</sup>

Donaldson suggests the following fundamental rights as a moral minimum:

1. The right to freedom of physical movement
2. The right to ownership of property
3. The right to freedom from torture
4. The right to a fair trial
5. The right to nondiscriminatory treatment
6. The right to physical security
7. The right to freedom of speech and association
8. The right to minimal education
9. The right to political participation
10. The right to subsistence<sup>21</sup>

Instances of these rights, according to Donaldson, include publicly shaming or penalizing corporations for not providing safety equipment to protect employees from serious hazards (the right to physical security), using coercive tactics to prevent workers from organizing (the right

to freedom of speech and association), employing child labor (the right to minimal education), and bribing government officials to violate their duty or seeking to overthrow democratically elected governments (the right to political participation).

Donaldson recognizes that it may be impossible to observe all these rights, especially in less-developed countries where human rights violations are routine. However, insofar as the acceptance of a practice in a host country is due to its low level of economic development, we can perform what he calls the *rational empathy* test:

Would we, in our home country, regard the practice as morally permissible under conditions of similar economic development?

As previously discussed, this test employs home-country standards but asks us to apply them in a hypothetical situation of a lower level of development, which may have prevailed in the past.<sup>22</sup>

**APPLYING RIGHTS** Although Donaldson’s list of fundamental rights sets some minimal conditions for ethical behavior, it is not a complete guide for managers.

First, the bearing of these rights on controversial questions is not wholly clear.

**Example:** No one disputes that causing starvation by destroying farmland is a human rights violation. But what does the right to subsistence tell us about cases in which multinationals convert land from the production of domestic crops to foods for export? Even though the MNC is acting within its rights within a free market as a property owner, and even though the country may benefit from more productive use of the land, the ability of local people to feed themselves may be severely curtailed, especially if the increased income from export-driven production is not equitably distributed in the country. Has the multinational violated the right of these people to subsistence? To this kind of question, Donaldson’s rights-based approach offers little guidance.

Second, many of the most difficult moral questions in international business do not involve rights at all. Although rights violations by corporations receive great public attention, they are relatively infrequent. The critical issues at the forefront of global business today focus more on abuses of power by multinationals and on their failure to aid developing countries.

**Example:** The OECD Guidelines for Multinational Enterprises, adopted by the Organization for Economic Cooperation and Development (OECD), covers such matters as competing fairly, disclosing information, paying taxes, considering countries’ balance-of-payment and credit policies, utilizing appropriate

technologies, and aiding economic development. In general, the goal of the OECD guidelines is to achieve a smoothly functioning global economic system that spreads the benefits widely, rather than to protect people's rights.

In sum, guidelines based on human rights provide a bedrock moral minimum. As a recent special report from the Secretary General of the United Nations asserts, not only do states have the duty to *protect* human rights, but multinational corporations have a responsibility to *respect* rights in countries where they operate and to *remedy* situations when rights are infringed.<sup>23</sup> This "Protect, Respect, and Remedy" framework forms the core of the United Nations Guiding Principles on Business and Human Rights. However, the application of these rights-based guidelines is difficult in more controversial situations where guidance is most needed. It is unclear, for example, what *type* and *degree* of remedy multinational corporations should provide when the violation of rights is due largely to a weak or corrupt government. The guidelines are also inapplicable to many other pressing matters, such as whether cooperation between a multinational corporation and a state should be suspended due to the government's violation of its citizens' rights in areas unrelated to the cooperative venture.

### 14.2.2: Welfare

Richard DeGeorge offers seven basic guidelines for multinational corporations that cover a variety of moral considerations, including rights. However, several of these rules concern avoiding harm and providing benefits. His guidelines are as follows:

1. Multinationals should do no intentional direct harm.
2. Multinationals should produce more good than harm for the host country.
3. Multinationals should contribute by their activity to the host country's development.
4. Multinationals should respect the human rights of their employees.
5. To the extent that local culture does not violate ethical norms, multinationals should respect the local culture and work with and not against it.
6. Multinationals should pay their fair share of taxes.
7. Multinationals should cooperate with the local government in developing and enforcing just background institutions.<sup>24</sup>

The first three of these guidelines express in different ways a duty to consider the welfare of people in a host country. The first, *do no intentional direct harm*, is vacuous if it excludes all actions with a legitimate business purpose.

No company intends to do harm; any harm results rather from its regular business activity. However, a company can engage in such activity knowing that harm will result. In some instances, this harm may be wrong, as when a firm produces oil in such a way that the land is polluted. On the other hand, a firm might open a plant that, because of its efficiency, will drive local competitors out of business. This latter result, unlike the former, is not wrong but is merely the working of market forces. In a well-functioning economy, more efficient producers should replace the less efficient. For the same reason, polluting oil production (Is there any other kind?) may be acceptable if the benefits outweigh the costs. What DeGeorge's first guideline presumably excludes is pollution that results from unjustifiably low standards. What standards ought to be adopted, however, is a question not merely about the harm done but about the benefit gained—and also about how these ought to be distributed.

The same problems afflict DeGeorge's second guideline, *do more good than harm*. Economic theory tells us that all voluntary exchange results in more good than harm for the reason that no one makes a trade that is not beneficial. Thus, as long as a multinational corporation offers employment in a factory and workers in a developing country are willing to accept, then everyone is better off. This defense of multinationals' presence raises two questions.

- How much more good than harm should a multinational bring to a country like Indonesia?
- Second, does it matter that multinationals are often able to use their market power to reap most of the benefit, leaving the host country with a narrow balance of good over harm?

The answers to these questions depend not on whether more good than harm is produced but on whether the outcome is obtained justly.

Multinationals are criticized primarily in cases where they take more than a fair share by exploiting their superior position in an imperfect market. A developed country, such as the United States, attempts to maintain perfect markets by preventing monopolies and other conditions that reduce fair competition. However, the marketplace that MNCs encounter in less-developed countries is highly imperfect. Under such circumstances, some outcomes may be criticized for resulting from unfair competition. As Manuel Velasquez observes, DeGeorge's approach "fails to take seriously the importance of justice in evaluating the activities of multinationals."<sup>25</sup>

### 14.2.3: Justice

Much of the criticism of multinational corporations rests on considerations of justice. Even when MNCs respect human rights and produce more good than harm, their

activities may still be criticized for being unfair or unjust. This is true even for the outcomes of voluntary market exchanges when they occur in imperfect markets, as when a multinational exploits a monopoly position.

**DISTRIBUTION OF BENEFITS** One kind of unfairness cited by critics is the often one-sided distribution of the benefits from foreign investment. Certainly, the gap between rich and poor countries is an urgent moral concern, and multinational corporations have much to offer. Thus, the third of DeGeorge's guidelines is that "[m]ultinationals should contribute by their activity to the host country's development." The main questions, however, are:

1. Who should act to aid the development of the country where a foreign business is investing?
2. What should be done to aid in this development?

National governments and world organizations are the primary actors, and it is questionable what role multinationals should play. What should they do to aid development other than engage in business activity?

The answer to the first question depends, in part, on how we answer the second question about what should be done. What is the most effective strategy for aiding developing countries? The main approach being taken today is to increase foreign investment and export production in an increasingly integrated world economy. If this development—generally called *globalization*—is the most effective strategy, then multinational corporations can contribute best by being efficient—but responsible!—businesses. Indeed, if MNCs are expected to expend resources on development, they may then choose not to invest in poorer countries, thus depriving them of any aid. However, opponents of globalization, such as the protesters at meetings of the World Trade Organization (WTO), propose other strategies for development that would place greater responsibilities on multinational corporations.

**RULES OF THE MARKET** Another kind of unfairness is violating the rules of the market, which is to say engaging in unfair competition and otherwise taking unfair advantage. One example is the ability of multinationals to avoid paying taxes by means of *transfer pricing*. Transfer prices are the values assigned to raw materials and unfinished products that one subsidiary of a company sells to another. Because transfer prices are set by the company and not the market, they can be raised or lowered so that most of the profits are recorded in countries with low tax rates. This use of transfer pricing is facilitated by the fact that multinationals are usually able to avoid disclosure of the relevant financial information. As a result, host countries often have little knowledge of a company's true financial situation.

Tax avoidance through transfer pricing is a critical problem for both developed and developing countries. Approximately a third of world trade takes place within

firms, so the possible loss of tax revenues is enormous. Consequently, the major countries of the world are trying to tighten accounting standards to prevent abuses. The OECD Guidelines for Multinational Enterprises requires firms to disclose financial statements on a regular basis and provide relevant information requested by taxing authorities. Furthermore, the Guidelines states that an enterprise should "[r]efrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed." This arm's-length standard is feasible when a market exists for the good in question, and for other goods a market price can be approximated by calculating the costs of production.<sup>26</sup>

If avoiding taxes by means of transfer pricing violates no laws, why should multinationals not take full advantage of this opportunity?

The same question can be asked of paying bribes, offering kickbacks, and similar practices. One answer, offered by Norman E. Bowie, is that these actions violate the rules that are required for markets to operate. The very possibility of market exchanges depends on the general observance of certain rules of honesty, trust, and fair dealing. Because businesses benefit from the marketplace that these rules make possible, they are taking an unfair advantage, being a freeloader so to speak, by simultaneously violating these rules. "Contrary behavior," Bowie writes, "is ultimately inconsistent and self-defeating."<sup>27</sup>

An obvious difficulty is determining the essential rules for markets to operate. That problem aside, is avoiding taxes by means of transfer pricing really a violation of market morality? One might argue that transfer prices should be set in ways that have the clear economic purpose of enabling a company to compete effectively in the marketplace. Setting transfer prices for no purpose other than reducing taxes is not a genuinely competitive activity but merely an exercise in tax reduction for its own sake. Indeed, whether a transaction serves a reasonable business purpose is a test that U.S. courts use to determine whether a tax shelter is legal.

Individually, the concepts of rights, welfare, and justice do not provide complete guidance for MNCs in addressing the many moral challenges of operating in a global environment, but each one is appropriate for certain problems, and used together they form a powerful resource. The successful use of these guidelines depends on a careful analysis of any given ethical problem to determine the relevant moral considerations and the specific factual details of the situation. These guidelines cannot be applied, moreover, without a deep understanding of and respect for the local context—the history, politics, economy, and culture—of the country in question. The guidelines

can gain further force and clarity by being incorporated into international codes of ethics to which multinational corporations can subscribe.

#### 14.2.4: International Codes

Given the diversity of ethical outlooks in the world, is it possible to agree on a single code of ethics for business worldwide? Such a goal must be achievable if globalization is to succeed. The theologian Hans Küng has observed that “the very phenomenon of globalization makes it clear that there must also be a globalization of ethics.”<sup>28</sup> Substantial agreement is being achieved through a number of codes that have been developed by international organizations involving governments, international governmental bodies (such as the United Nations), multinational corporations, and other private organizations, including non-governmental organizations (NGOs). All of these diverse actors are participants in global civil society.

The foundational document for human rights is the 1948 United Nations Universal Declaration on Human Rights. In 1966, the United Nations adopted two agreements that have subsequently been ratified—and, to differing degrees, implemented—by the major countries of the world: the International Covenant on Social, Economic, and Cultural Rights and the International Covenant on Civil and Political Rights. Since 1972, the United Nations had been developing a code of conduct for multinational corporations, a project that never came to completion. However, in 2000, the UN, under the leadership of Secretary-General Kofi Annan, launched the Global Compact, which consists of 10 principles covering human rights, labor, anticorruption, and the environment. The premise of this agreement is that “business, as a primary driver of globalization, can help ensure that markets, commerce, technology and finance advance in ways that benefit economies and societies everywhere.” By 2014, more than 7,000 businesses in 145 countries had become signatories of the Global Compact.

The International Labour Organization, which dates from 1919 and is now a specialized agency of the United Nations, sets many international standards, including those of the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (1977). More recently, the OECD, whose members are the more developed countries of the world, has adopted the OECD Guidelines for Multinational Enterprises. Several interfaith religious bodies have developed codes. The most prominent are the Principles for Global Corporate Responsibility, adopted by the U.S.-based Interfaith Center on Corporate Responsibility and similar organizations in Great Britain, Ireland, and Canada, and the Interfaith Declaration on International Business Ethics, which resulted from a dialog among Christians, Jews, and Muslims.<sup>29</sup> A group of world

business leaders, meeting in Caux, Switzerland, developed the Caux Roundtable Principles for Business.

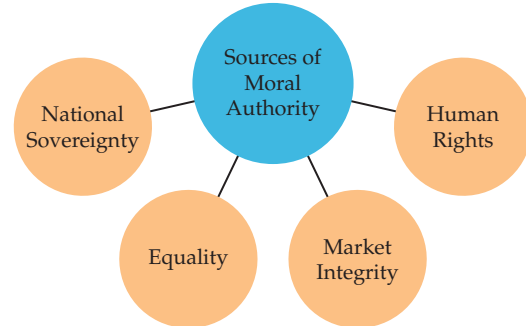
These codes have many features in common and cover the following areas:

1. employment practices,
2. consumer protection,
3. environmental preservation,
4. political involvement,
5. bribery and corruption, and
6. human rights violations.

They draw strength from the widespread recognition that the guidelines represent universal values, which give them moral authority. William C. Frederick finds four basic ethical concerns from which international codes derive moral authority: national sovereignty, equality, market integrity, and human rights (see Figure 14.1). Any guidelines not supported by these sources—to aid in a country’s development, for example—do not have strong moral authority and hence are less effective.

**Figure 14.1** Moral Authority of International Codes<sup>30</sup>

An effective code of ethics for international business derives its moral authority from a respect of four basic ethical concerns.



#### How are these codes enforced?

##### Global Civil Society?

The development and enforcement of these codes lie in the realm of global civil society, which is the result of a redistribution of power among nation states, international bodies, private corporations, industry groups, and private NGOs. With a decline in the power of nation states—and also in the absence of international government, which has not developed as many expected after World War II—the main alternative is voluntary, collaborative rule making by a combination of public and private actors. Regulation within a state consists of codified, legally enforceable rules that originate with legislatures, regulatory agencies, and other bodies with rule-making authority. Civil society regulation, by contrast, develops from multiple sources, largely outside governments, often in response to urgent needs for guidance.<sup>31</sup> The resulting rules

are commonly enforced through the benefits of compliance and the threat of retaliation for not cooperating. Although compliance is usually voluntary, countries and companies usually find it in their interest to abide by the major codes.

The rise of global civil society regulation poses great challenges for multinational corporations. Instead of merely passively complying with national laws and perhaps actively lobbying governments in nation states, MNCs have been thrust into an unaccustomed rule-making role in which they must interact extensively with nonstate actors, especially NGOs. In fulfilling this role, they assume a kind of political power that they do not possess in nation states.<sup>32</sup> This role requires MNCs to develop a high degree of competency in social matters in order to engage effectively in this global rule-making process, and it also requires them to exercise a degree of responsibility sufficient to gain legitimacy in this new role.

The guidelines for multinationals and the various international codes of ethics that are discussed in this section are applied in the following three sections to the problems of wages and working conditions, foreign bribery, and countries with repressive governments that violate human rights.

### WRITING PROMPT

#### International Codes of Ethics

How helpful do you think international codes are in guiding decisions and helping to resolve day-to-day ethical problems? What are the advantages and disadvantages of adopting individual company codes rather than industry-wide codes?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 14.3: Wages and Working Conditions

### 14.3 Describe the ethical issues in determining wages and standards for working conditions in international business, and factors that multinational corporations and foreign contractors should consider to improve on those set by market mechanisms

In 1998, Nike was the leader in the sports shoe industry, with annual sales of \$9.5 billion and a 40 percent share of the American sneaker market, when it became a lightning rod for worldwide protests over alleged “sweatshop” conditions in factories across Southeast Asia. In a May 1998 speech, Phil Knight, the founder and CEO, admitted that

“the Nike product has become synonymous with slave wages, forced overtime, and arbitrary abuse.”<sup>33</sup> How did a prominent company, whose “swoosh” logo is a symbol for the “Just Do It” spirit, come to be associated with deplorable labor practices?

#### Case: Nike in Southeast Asia

Nike’s phenomenal success is due to a visionary strategy that was developed by Phil Knight during his student days at the Stanford Business School. The strategy involves outsourcing all manufacturing to contractors in low-wage countries and pouring the company’s resources into high-profile marketing. One Nike vice president observed, “We don’t know the first thing about manufacturing. We are marketers and designers.”<sup>34</sup> Central to Nike’s marketing effort was placing the Nike “swoosh” on the uniforms of collegiate and professional athletes and enlisting such superstars as Michael Jordan and Tiger Woods. When Nike was founded in 1964, the company contracted with manufacturers in Japan, but as wages in that country rose, Nike transferred production to contractors in Korea and Taiwan. By 1982, more than 80 percent of Nike shoes were made in these two countries, but rising wages there led Nike to urge its contractors to move their plants to Southeast Asia. By 1990, most Nike production was based in Indonesia, Vietnam, and China.

In the early 1990s, young Indonesian women working in plants under contract with Nike started at 15 cents an hour. With mandatory overtime, which was often imposed, more experienced workers might make \$2 for a grueling 11-hour day. The Indonesian minimum wage was raised in 1991 from \$1.06 for a seven-hour day to \$1.24, only slightly above the \$1.22 that the government calculated as necessary for “minimum physical needs.” The women lived in fear of their often brutal managers, who berated them for failing to meet quotas and withheld pay to enforce discipline. Indonesian labor laws, lax to begin with, were flouted with impunity by contractors, since the government was eager to attract foreign investment. Workers often toiled in crowded, poorly ventilated factories, surrounded by machinery and toxic chemicals. There was little effective union activity in Indonesia, and labor strikes were firmly suppressed by the army.

Nike’s initial response to growing criticism was to deny any responsibility for the practices of its contractors. Their stance was that these were independent companies from which Nike merely bought shoes. The workers were not Nike employees, and their wages were above the legal minimum and the prevailing market rate. When asked about labor strife in some factories supplying Nike, John Woodman, the company’s general manager for Indonesia, said that he did not know the causes and added, “I don’t know that I need to know.”<sup>35</sup> Mr. Woodman defended Nike by arguing, “Yes, they are low wages. But we’ve come in here and given jobs to thousands of people who wouldn’t be working otherwise.”<sup>36</sup>

Public concern about multinational corporations has focused in recent years on manufacturing companies, primarily in the footwear, apparel, toy, and electronics industries, and their relations with foreign contractors. Virtually all major manufacturers of consumer and light industrial products have adopted the strategy pioneered by Nike and outsourced the actual assembly to contractors in Southeast Asia and Central America. This development benefits consumers and industrial buyers everywhere by lowering the cost of goods, and jobs are created in countries that desperately need them. Overall, the manufacture of goods in countries with low labor costs is advantageous to developed and developing countries alike.

To many critics, however, the benefits must be weighed against a long list of wrongs that includes very low wages and substandard working conditions, as well as the use of child labor, lack of contribution to local development, and association with repressive regimes. Some of the factories operated by multinationals and their foreign contractors are alleged to be “sweatshops” of the kind that operated in developed countries until the passage of protective legislation in the early twentieth century. The critics also question the ability of foreign contracting to advance economic development. Instead of improving the lives of people, they charge, the contracting system leads to greater misery for the bulk of the population and to a wider gap between the rich and the poor. Although outsourcing may benefit developed countries by the cheaper products that are imported, these countries may be harmed when the exported jobs create unemployment at home.

### WRITING PROMPT

#### “Made in . . . ?”

If consumers look at product labels to see where the items were manufactured, what additional information about the working conditions in that country would they need to be aware of in order to make an ethical choice about purchasing it?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## 14.3.1: Setting Wages

How should the standards for wages and working conditions be determined?

One answer is that these standards should be set by the market. In developed countries, the determination of wages and working conditions results primarily from the competition among employers for desirable workers, which compels them, generally, to offer high wages and good working conditions. On this view, there is nothing unjust about jobs with lower pay and poorer working

conditions. As long as workers are willing to accept employment on the terms offered, then almost any mutually agreeable arrangement is justified. It then follows that no wage can be too low in a free market. However, using the market as a mechanism for determining acceptable standards for wages and working conditions in developing countries encounters two obstacles.

1. *Need for Minimum Standards.* First, even developed countries do not rely solely on the market but set certain minimum conditions by law, such as minimum wage laws, fair labor standards, and health and safety regulations. These conditions reflect, in part, the recognition of certain human rights that ought to be observed in all economic activity. Thus, one rationale for minimum wage laws is that it is unjust to pay workers less than a certain amount. That is, some wages are unjustifiably low, even if enough workers would accept them. Although multinational corporations and their foreign contractors generally pay the legal minimum wage in the countries where they operate, this amount often provides only a basic subsistence for one person, if that. Consequently, critics argue that the standard should be a “living wage” that enables a worker to live with dignity and support a family, given the local cost of living.
2. *Poor Market Conditions.* The second obstacle to using the market to set wages and working conditions is the possibility that the conditions for a free market that generally prevail in developed countries are lacking in the less-developed world. In particular, the mass of unemployed, desperately poor people in less-developed countries constitutes a pool of workers willing to accept bare subsistence wages. The market for labor in any given country may also be artificially low because of lax enforcement of worker protection laws and political repression that prevents workers from organizing. Although the role of correcting such market failures generally falls to national governments—by enacting and enforcing minimum wage laws, for example—this form of protection is often uncertain in less-developed countries with weak, corrupt, or oppressive governments.

Consequently, we need to consider the extent to which market forces should be allowed to operate in the setting of wages and the extent to which principles of human rights ought to be applied. In setting wages, the two extremes are a human rights-based “living wage” and a pure “what the market will bear” economic determination—with the possibility of somehow combining elements of both.

In addition to identifying the morally appropriate level of pay and the method for determining this level, there are questions about responsibility:

Should the tasks of identifying and determining wage levels be the responsibility of multinational corporations or the host countries—or some combination of the two?

**ARGUMENT FOR MARKET WAGES** In support of the market mechanism, economists argue that the wages paid by multinational corporations and their foreign contractors are usually above the minimum wage and the prevailing market rate. As a result, the jobs in these factories generally pay better than work in local enterprises, and regular employment in the formal economy is vastly superior to work in the informal sector, which includes agriculture, domestic service, and small, unregulated manufacturing. Even so, the wages paid for factory work are seldom sufficient to provide what the nation's government calculates as the minimum for a decent standard of living or the minimum physical needs for one person, let alone a family. In many poor countries of Southeast Asia and Central America, the minimum wage set by law is below the official poverty level.

Moreover, economists warn that raising the pay scales in a developing country has serious adverse consequences. Well-intentioned efforts to improve the condition of factory workers will ultimately reduce the number of jobs and the level of foreign investment. If a government raises the minimum wage or multinationals and foreign contractors are pressured to pay above-market wages, the result will be a reduced incentive to relocate jobs from higher-wage countries, which tend to have more productive workers and a better infrastructure for manufacturing. Workers in developed countries command a higher wage because of greater skills and knowledge, as well as access to technology; infrastructure, such as transportation and markets, further increases the advantages of employing high-wage workers. Consequently, firms will have little reason to move to a less-developed country unless it offers significantly lower labor costs to compensate for the lower productivity and inferior infrastructure.

Low labor costs constitute a competitive advantage for a poor country, and attracting investment on this basis provides jobs that can lead to greater development. Indeed, formerly low-wage countries, such as Korea, Taiwan, and Malaysia, have successfully employed this strategy for creating higher-paying jobs. If firms do not take advantage of the low-cost labor in countries like Indonesia and Vietnam, then they are depriving these countries of the opportunity to use their main competitive edge, namely unemployed workers, to begin the process of development. This competitive advantage is also lost if multinational corporations and their foreign contractors are required, say by public pressure, to pay above-market wages, since there would be little incentive for multinationals to relocate.

This economic argument shows, first, why less-developed countries should not raise the minimum wage beyond the market value of its labor. In a developed country, raising the minimum wage generally benefits low-wage workers without much effect on others (although some argue that low-wage workers are harmed by reduc-

ing the number of jobs available), but the effect in a less-developed country is different. A relatively small minority of urban workers, who already make above-average wages, may benefit, but the vast majority will suffer for the lack of jobs, and the economy will not develop for lack of foreign investment. For this reason, the economist Jagdish Bhagwati contends, "Requiring a minimum wage in an overpopulated, developing country . . . may actually be morally wicked."<sup>37</sup>

**ARGUMENTS AGAINST MARKET WAGES** Critics of the economic argument counter that it fails to consider the possibility of exploitation. It assumes that whatever wages people are willing to accept is just without considering the lack of alternatives for many workers, who are, arguably, coerced into settling for low pay. However, most of the jobs in question are among the best paying in these less-developed countries, so the case for exploitation is weak. Moreover, the "living wage" position seems to entail that no job at all is preferable to one below the living-wage standard. Although developing countries are forced to keep wages low in their competition with each other to attract foreign investment, they still seem to prefer all the low-wage jobs they can get, regardless of whether they pay a "living wage."

A second argument of critics is that higher pay could be offered without much impact on multinational corporations or their customers in developed countries. Critics observe that the labor cost for a pair of shoes or a shirt is usually a few cents and that paying a few cents more would add little to the ultimate price. However, this observation overlooks the point that the labor of any one worker may earn only a few cents, but much more labor goes into a pair of shoes or a shirt than that required for assembly. If all the workers who make the raw materials and provide other resources involved in production are considered, then paying each one a few cents more per item for his or her contribution would constitute a considerable amount and would discourage a multinational from investing in a developing country.

The dispute between those who advocate paying the market rate for labor and those favoring a "living wage" is not over the ultimate end, which is to improve the welfare of people in developing countries. The difference lies in the appropriate means. Economists argue that requiring higher wages is counterproductive; it harms the very people we are trying to benefit. The only path to prosperity is economic development, and this requires an attractive climate for foreign investment. Proponents of a "living wage" believe, on the other hand, that payment of wages above a certain level is morally required. To offer less than a "living wage" is to unjustly exploit an opportunity for cheap labor.

As discussed earlier, a minimum wage is intended to protect workers from the exploitation that could result if

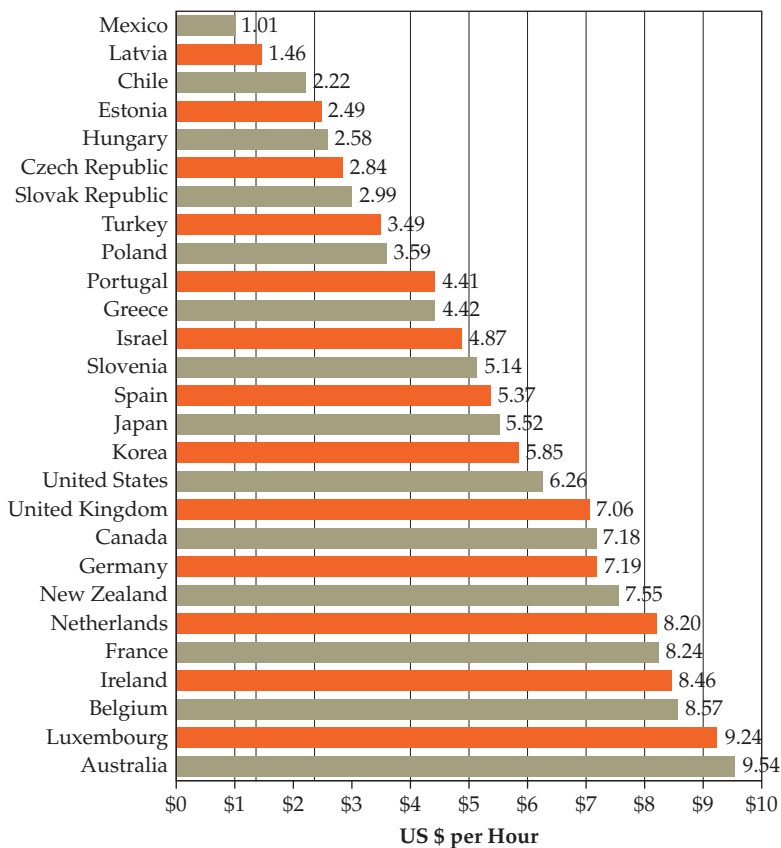
wages were set solely by market forces, but most often it is not a “living wage.” See Figure 14.2 below.

**Figure 14.2** Legal Minimum Hourly Wage in OECD Countries, 2015

The Organization for Economic Cooperation and Development (OECD) is an international organization that promotes economic growth and development. The graph shows the minimum wage in some OECD nations as the net hourly pay (after taxes), adjusted for purchasing power in U.S. dollars. This means that the listed wages allow workers to buy a comparable amount of goods as they would in the U.S. The adjusted wages in this chart do not “buy more” in countries where the cost of living is lower.

Based on these values, would you consider the minimum wage a “living wage” in any of the countries shown? How many hours would a minimum-wage earner in each country need to work in order to purchase basic life necessities or maintain a modest standard of living?

**SOURCE:** OECD, “FOCUS on Minimum wages after the crisis: Making them pay,” May 2015



### 14.3.2: Working Conditions

When the television personality Kathie Lee Gifford was confronted in 1996 with evidence that the line of clothes she endorsed was made in Honduras by young girls 13 and 14 years old, working 20-hour days for 31 cents an hour, she resolved to correct these abuses. The same year, *Life* magazine published a photograph of a 12-year-old boy in Pakistan stitching a Nike soccer ball. Phil Knight replied that “Nike has zero tolerance for under-age labor.” Reports on contractors for other American companies described women who were confined to factory compounds, berated and beaten for violating rules or failing to meet quotas, forbidden to use toilets, and fired for protesting or attempting

to organize. In some instances, young women have been forced to take contraceptive pills or undergo pregnancy tests, and they have been dismissed for becoming pregnant. Many factories lack adequate ventilation, sanitation facilities, medical supplies, and fire safety provisions, and workers often have little protection from dangerous machines and toxic chemicals.

Certainly, some deplorable working conditions are morally unjustifiable. However, the economic argument about wages also applies to working conditions inasmuch as both are matters of cost. In some instances, though, workplace abuses—such as degrading punishment, forced overtime, and confinement to company quarters—have little or no economic justification. However, costs, as well as benefits, are relevant factors in determining a morally justifiable level for working conditions. According to a World Bank report, “Reducing hazards in the workplace is costly, and typically the greater the reduction the more it costs. . . . As a result, setting standards too high can actually lower workers’ welfare.”<sup>38</sup>

One reason for this outcome is that investment to improve working conditions may come at the expense of wages. More significantly, if higher standards inhibit foreign investment, then fewer jobs are created and more of those available are in local industries with lower pay and working conditions. Still, working conditions below some basic level should not be permitted by any multinational corporation, and a consensus has emerged among multinational corporations about this level. The main focus now is on how best to implement working condition standards.

**DEVELOPING A CODE** For many companies, the first step has been to adopt codes of conduct for their own operations and those of contractors. In 1992, six years before conditions in its factories across Southeast Asia sparked protests around the world, Nike adopted a “Code of Conduct” and a “Memorandum of Understanding,” which were included with all contracts. The Nike code specified the following conditions:

- It forbade hiring anyone under 18 in shoe manufacture and under 16 for producing clothing (unless higher ages are mandated by law).
- It stipulated that workers be paid the higher of the legal minimum wage or the prevailing wage, with a clear, written accounting of all hours and deductions.
- Although forced overtime is permitted, provided employees are informed and fully compensated according to local law, the code required one day off in seven and no more than 60 hours a week.



Nike also developed a comprehensive Management of Environment, Safety and Health (MESH) policy that provided for safety standards, a safety committee in each factory, and free personal protective equipment for at-risk employees.

Although these actions addressed the major areas of concern, critics charged that Nike had not gone far enough by 1992 in setting high standards. In 1990, Reebok, a Nike competitor, adopted a far-reaching human rights policy and inserted human rights language in its contracts. Reebok also committed itself to auditing its contractors for compliance with the human rights policy. Nike, too, agreed to auditing by hiring the firm Ernst & Young to conduct site visits of its contractors. In 1996, Nike also hired the civil rights leader Andrew Young to investigate factories in Asia and to report his findings. Both efforts were denigrated by critics, who challenged the competence of these parties to conduct thorough audits and questioned their independence inasmuch as Nike was footing the bill. Nike's commitment was further undermined when an internal Ernst & Young report, leaked to the press in 1997, revealed serious health and safety issues in a Vietnamese factory.

**INDUSTRY ACTION** As illustrated by the struggles of Nike and Mattel (discussed in Case: Mattel's Toy Woes), the challenges of managing foreign contractors are beyond the capability of any single company and require an industry-wide approach.

- First, imposing higher standards on contractors, monitoring their factories, and enforcing compliance are costly, and any firm that incurs these costs when its competitors do not is put at a competitive disadvantage.
- Second, each firm deals with thousands of contractors, which in turn manufacture for many brands. The only solution, therefore, is an industry-wide effort.

The first initiative occurred in 1997 with the launch of the Apparel Industry Partnership (AIP), which Nike immediately joined. Convened by the White House, a group of industry, labor, consumer, and human rights leaders committed themselves to develop a strong workplace code of ethics with internal monitoring and an independent, external monitoring system. The AIP was succeeded the next year by the Fair Labor Association (FLA), which has preserved the same goals. In response to the concern of college students, the Worker Rights Consortium (WRC) was organized to address specifically the conditions under which collegiate apparel with a school's logo is manufactured.

The experiences of the FLA and the WRC reveal substantial agreement on principles and standards, although the issue of a "living wage" has been divisive. The main stumbling block has been monitoring. The practical difficulties of monitoring tens of thousands of contractors

around the globe—not to mention the cost of \$3,000 to \$6,000 for each factory visit—are daunting enough, but the participants have sharply disagreed on issues of principle. For starters, who should do the monitoring? Accounting firms often lack expertise in local situations, whereas activist groups may not be wholly objective. What qualifications should monitors have? How should audits be conducted? Should audits be unannounced or scheduled in advance? Should all of a firm's contractors be audited or only a sample? Should the reports be made public? What actions should be taken when violations are discovered?

**REMAINING PROBLEMS** As these questions suggest, the solution to the problem of sweatshops requires a sustained, committed effort by all concerned parties. Considerable progress has been made on working conditions—but not on wages. A *New York Times* article profiled a woman who was fired in 1995 for protesting conditions at a factory in El Salvador. Six years later, the woman returned to work at the factory where workers now enjoy coffee breaks in a terrace cafeteria and work in clean, breezy surroundings, but she earns only 60 cents an hour, 5 cents more than before.<sup>39</sup>

Child labor presents an especially thorny issue. Although an estimated 150 million children under the age of 14 work worldwide, less than 5 percent of these make goods for export. The vast majority are employed in the informal economy that contains the most dangerous jobs. Virtually every country bans child labor, but enforcement is often ineffective. Although multinationals should abide by the law and refrain from employing children, the main challenge is how to deal with existing factories that employ children. A *New York Times* editorial observes, "American consumers are right to insist that the goods we buy are not made with child labor. But these efforts will backfire if children kicked out of these factories drift to more hazardous occupations."<sup>40</sup>

In response to this problem, the International Labour Organization has worked with governments and businesses to establish special schools for approximately 10,000 children who worked in garment factories and to pay their parents for the lost wages. Ultimately, the solution to the problem of child labor is not merely to prohibit the employment of underage workers but also to provide schooling for children and jobs for parents so that child labor is no longer an economic necessity.

## 14.4: Foreign Bribery

### 14.4 Evaluate the various forms of bribery and factors that foster them, the ethical problems with bribery, and the diverse means and strategies for combating bribery

Bribery is one of the most common and controversial issues that multinational corporations face. Bribery is universally condemned, and no government in the world legally

permits the bribery of its own officials. However, bribery exists to some extent in every country and is endemic to more than a few. The main ethical question about bribery is whether companies are justified in making corrupt payments when they believe them to be necessary for doing business in a corrupt environment.

Although the demand for a bribe may be unethical, is it unethical to give in to a demand?

Those who pay bribes often appeal to the slogan, “We don’t agree with the Romans, but find it necessary to do things their way.” Others may defend their actions by citing the fine line between outright bribery and other kinds of more innocent payments. Some even argue that bribery, under certain conditions, is a beneficial practice. The United States has legally prohibited certain kinds of payments since the passage of the Foreign Corrupt Practices Act (FCPA) in 1977, and more recently other developed countries have agreed to make payments to foreign officials illegal. Such laws require some justification, though, since they put the companies of these countries at a disadvantage in competing with less scrupulous rivals.

The issue of bribery is far from simple.

- First, the term “bribe” is vague. It applies to many different kinds of payments with varying interpretations, ranging from gift giving and influence peddling to kickbacks and extortion. There is need, therefore, to develop a definition and make some distinctions, as well as to understand the factors that foster bribery and allow it to flourish. An understanding of these causes enables us not only to explain where bribery is more likely to occur but also to develop means to reduce it.
- Second, this section addresses the question of what is wrong with bribery and the arguments, advanced by some, that question the harm.

Finally, the means for combating bribery, including the U.S. Foreign Corrupt Practices Act and its justification, are discussed.

### 14.4.1: What Is Bribery?

The Foreign Corrupt Practices Act (FCPA) forbids American corporations to offer or make any payment to a foreign official for the purpose of “influencing any act or decision of such foreign official in his official capacity or of inducing such foreign official to do or omit to do any act in violation of the lawful duty of such official” in order to obtain or retain business.<sup>41</sup>

This legal prohibition accords with standard philosophical definitions of bribery.<sup>42</sup> The key point is that a bribe is a payment made with an intention to corrupt and accepted in a way that is corrupting. More specifically, a public official has a duty to make all decisions in the

interest of a country’s people, and a briber makes a payment with the intention of inducing an official to violate that duty. This violation of duty is a form of corruption. A corrupt official, the bribee, is one who willingly accepts a payment—often after a request or a demand—that would lead him or her to act in a way that violates a duty. A bribe occurs once an offered payment has been accepted, regardless of whether the bribee acts as the briber intends. Indeed, such a failure to achieve the desired result is one of the risks of offering a bribe to a corrupt official since such a dishonest person is not easily trusted.

In a common scenario, bribes are made in cash payments either directly in “under-the-table” transactions or indirectly through deposit in a bank account. However, the forms of payment, which are numerous, can include seemingly legitimate arrangements, such as:

- a relative or confederate is hired, usually for little or no work;
- goods or services are purchased from a favored supplier, usually at inflated prices;
- the official or another party becomes a partner in a joint venture, usually sharing in the profit but making no investment; or
- a contribution is made to some philanthropy that is usually a front for personal gain.

Typically, bribes are not paid directly by employees of a bribing company but funneled indirectly through locally hired consultants or joint-venture partners, and funds for the bribes may be disguised as consulting fees or joint-venture expenses.

The purposes for which bribes are paid are similarly diverse. They include attempts to secure the following:

- the approvals of bids or sales, which are commonly sought by bribery
- licenses to operate
- access to scarce or subsidized resources
- favorable legal rulings
- avoidance of investigations or political pressures, and the like.

The only common factor is that what is sought is something within the decision-making authority of a public official who has the discretion to grant or withhold it.

Like other kinds of misconduct, the incidence of bribery is a function of the opportunity presented, the amount to be gained, and the likelihood of success—or alternatively the risk of prosecution. Consequently, bribery is more likely to occur in countries in which the approval of government officials is required for doing business. In a country with well-developed laws and regulations that allow little discretion for public officials, and with a small public sector that leaves most business to be conducted in markets by private

individuals and corporations, there is little opportunity for bribes to be demanded or offered. On the other hand, in a state-dominated economy in which much business is conducted with the national or local government, where public officials make key decisions about the purchase of goods, the approval of projects, and the like, great opportunities are created for bribes to be demanded and/or offered.

For example, a bribe might be paid not only to gain approval of a bid for the operation of, say, a large construction project, but also to gain advance information about the bid requirements or to shape the terms of the bid requests to favor one bidder. Economies in which multiple licenses are needed to operate a business, or in which the state controls access to scarce or subsidized resources, are also fertile conditions for bribery to occur. Bribes may also be paid to avoid costs, such as those associated with paying taxes or complying with regulations. Bribes are more likely to occur when the risks of discovery and apprehension are low because of lax or erratic enforcement. Even a high risk for accepting bribes may be offset by the size of the bribe offered, which leads to the dilemma that more vigilant enforcement of antibribery laws may reduce small payments but increase the amount that other officials demand in order to make bribery worth the risk.

### 14.4.2: What's Wrong with Bribery?

The immorality of demanding or accepting bribes is implicit in the definition of bribery: A government official is violating a duty, which in itself is a wrong. In addition, inducing such a violation by offering a bribe is commonly recognized as wrong as well. Corrupting others is as wrong as being corrupt oneself. Beyond these obvious points, however, lies the more relevant question of whether the wrongfulness of bribery is of sufficient gravity to make it an object of concern.

How serious is the problem of bribery?

If bribery is relatively harmless or even somewhat beneficial, then there is no reason to make it illegal by such means as the FCPA and to expend great resources combating it.

Some economists have argued that bribery has the capacity to aid development by introducing an element of efficiency by “greasing the wheels” in an otherwise inefficient economy.<sup>43</sup> These defenders of bribery begin with the observation that in many developing economies, the government officials and other elites tend to dominate the economy for their own benefit, and they are often indifferent or hostile to foreign investors and local entrepreneurs, who may upset the cozy status quo. When outsiders are able to overcome this bureaucratic inertia by paying bribes—which they can afford to do because of their greater efficiency in conducting business—they aid development by putting resources to their most productive use. Indeed, competition among potential bribers itself is a factor in promoting efficiency, since the party that is able to afford

the highest bribe is likely to be the most efficient producer. Combating bribery, on this view, may impede development by maintaining an inefficient status quo. Thus, the political scientist Samuel P. Huntington observes, “In terms of economic growth, the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized and honest bureaucracy.”<sup>44</sup>

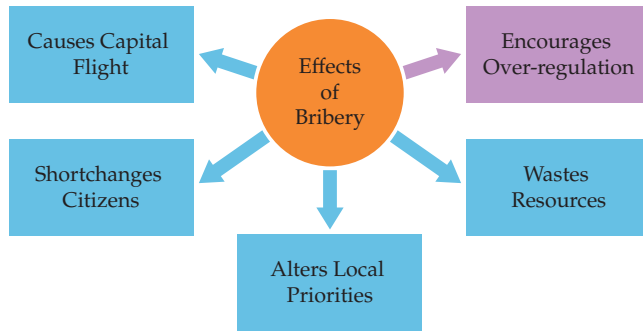
The “greasing the wheels” argument does not give sufficient weight to the full costs of bribery in a less-developed country.<sup>45</sup>

### What are the economic costs of bribery?

These can be outlined as follows

- **Causing capital flight.** Bribery reduces the resources available in an economy when elites transfer money out of the country into secret foreign bank accounts. In the case of some African countries, this loss has amounted to billions of dollars.
- **Shortchanging citizens.** Money for bribes need not come from the greater efficiency of the bribe payer but from overcharging or delivering substandard products or services. In this way, the ultimate purchasers, the citizens of a country, are shortchanged by getting less for what they pay. Ordinary citizens may lose in other ways when taxes are raised or spending is cut to cover the loss when the government overpays for goods and services, or when the bribes lead to lax enforcement of regulations concerning tax collection, working conditions, or environmental protection.
- **Altering local priorities.** The spending priorities of a country may be distorted when government officials choose large, complex projects from which bribes can be extracted instead of more urgently needed goods and services that do not offer the same opportunities for demanding bribes. Thus, developing countries often end up with an abundance of dams and power plants to the neglect of education and medical care.
- **Wasting resources.** The sheer amount of time that business people in corrupt countries must spend dealing with government officials and complying with needless regulation detracts from productive activity.
- **Encouraging over-regulation.** Finally, the potential for demanding bribes leads government officials to create even more efficiency-impeding laws and regulations that confer ever more discretion on them. One expert on corruption writes, “Thus, instead of corruption being the grease for the squeaky wheels of a rigid administration, it becomes the fuel for excessive and discretionary regulations. This is one mechanism whereby corruption feeds on itself.”<sup>46</sup>

Use Figure 14.3 to review these adverse effects of bribery on the host country.

**Figure 14.3** Economic Effects of Bribery

In addition, bribery has many adverse noneconomic consequences. For one, it enriches elites in a country, which leads to greater inequality and also to loss of public confidence in government. Susan Rose Ackerman writes, “Systematic corruption undermines the legitimacy of governments, especially in democracies, where it can even lead to coups by undemocratic leaders. By contrast, non-democratic governments can use corruption to maintain power by spreading benefits.”<sup>47</sup> These factors may also result in greater political instability, which, in turn, discourages foreign direct investment. Furthermore, in a culture of bribery, the most unscrupulous prosper, and others must emulate them if they are to succeed. Such a corrupt culture is corrosive for the development of personal character and a healthy social order.

Thus, the evidence is that bribery imposes a great cost, both economic and noneconomic, on developing countries. Although estimates are difficult to formulate across so many diverse countries, one calculation is that bribery constitutes an additional tax of 20 percent on investment.<sup>48</sup> Thus, each investment dollar could bring, on average, one-fourth more development if the country could eliminate the damaging effects of bribery.

### WRITING PROMPT

#### The Costs of Institutionalized Bribery

What additional costs might bribery impose on a company beyond the amount of the payment? Explain whether or not the costs that bribery also imposes on a country should be the responsibility of the company paying the bribe.

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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### 14.4.3: Combating Bribery

If bribery is morally wrong as well as economically and socially undesirable, then corporations and governments should take reasonable steps to reduce the incidence of bribery around the world. Unfortunately, bribery is difficult to

combat due to its secretive nature and deep penetration. It occurs, of necessity, out of the public eye, and it often involves networks of individuals and institutions that thwart efforts to prosecute wrongdoers and to bring about reform.

For example, when the proceeds from bribery are widely shared by government officials, including bureaucrats, legislators, and judges, then everyone who might act constructively has an interest in maintaining a corrupt system. Moreover, bribery is a classic collective choice problem in that no single honest company or official can singlehandedly make any difference: Any company that refuses to offer bribe or any official who declines to accept one will have no effect as long as others are willing to engage in the practice. Any solution to the problem must involve action that affects everyone. Finally, any effective action must address the root causes of bribery, which are the conditions that create numerous opportunities for bribes in substantial amounts without significant risk.

Table 14.1 lists entire sectors of industries that business executives worldwide believe to be particularly prone to bribery, according to Transparency International’s 2011 Bribe Payers Index.

**Table 14.1** World’s 10 Industries Most Likely to Involve Bribery

Based on survey responses by business and government officials in various countries, a scale from 0 to 10 has been created Transparency International, an anti-corruption organization, where 0 represents the belief that bribery always occurs and 10 that it never occurs. The industries are listed in order from most to least likely to involve bribery.

Industry Sector	Score (0–10)
Public works contracts and construction	5.3
Real estate, property, legal, and business services	6.1
Utilities	6.1
Oil and gas	6.2
Mining	6.3
Power generation and transmission	6.4
Pharmaceutical and healthcare	6.4
Heavy manufacturing	6.5
Arms, defense and military	6.6
Fisheries	6.6

SOURCE: Transparency International, “Results by Sector,” *Bribe Payers Index Report 2011*.

### WRITING PROMPT

#### Individual Actions in a Corrupt System

Consider the different industries listed in Table 14.1 above and the factors that might make them particularly susceptible or conducive to bribery. Do you think it is possible for a single solution to effectively stop bribery in all of these areas, or would each area require a unique approach? How might these approaches differ? Explain.

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**ANTI-BRIBERY STRATEGIES** It has already been observed that the opportunities for bribery are created in the area of overlap between business and government where public officials have discretionary authority to make decisions that affect economic activity.

**One strategy to combat bribery, then, is to alter the role of government in the economy.** Limiting government involvement and increasing the prominence of free markets is one possibility. However, merely limiting the involvement of government may not be an improvement if corruption is replaced only by oligopoly, in which elites can still make exorbitant profits.

Genuine progress can be made only by reforms that promote healthy competition and proper regulation. Such progress may occur with extensive government involvement in the economy as long as there are well-designed rules, known by all and impartially applied, that leave little room for discretion. The efficacy of such rules is increased by openness and accountability in the decision-making process. For example, the incidence of bribery might be reduced if fewer licenses were required for operating a business and the licensing process was made simpler and more routine. Similarly, the fewer government contracts that are let, the less opportunity there is for bribery, but the same result can be achieved if bidding on contracts is conducted openly and in accord with fair, consistently applied rules.

**Since much bribery involves civil servants in government bureaucracies, a second strategy consists of civil service reform.** Pay might be increased, for example, in order to reduce the temptation among low-paid officials to demand or accept bribes. In some countries, the pay of civil servants is extremely low on the assumption that they will supplement their meager wages with bribes, which becomes a self-fulfilling expectation. Reform might also include more selective recruitment and better training in order to build a more professional civil service. Higher pay for civil servants, accompanied by good pension, may reduce the incidence of bribery not only by removing the need for the income but also by making the jobs so attractive that the risk of losing them will deter bribe taking.

**A third strategy for reducing the opportunities for bribery consists of more careful selection of government projects.** This might be done by eliminating those that are most vulnerable to bribery and closely monitoring the ones that go forward. This check can be imposed most effectively on developing countries by funding agencies, such as the World Bank and the International Monetary Fund, as well as the investment banks that provide loans. These agencies and banks, most of which have adopted formal anti-bribery policies and procedures, combat bribery by evaluating the integrity of individual projects and the ability of the countries in question to control bribery, as well as by providing expertise and other

kinds of support for well-intentioned governments seeking to reduce bribery.<sup>49</sup> The motive for funding agencies and banks to consider bribery in their loan practices stems not only from an economic concern that their funds not be wasted through bribery but also from the recognition that the political conditions that foster bribery strongly impact economic development. In other words, they recognize that the economic function of lending cannot be separated from the politics of a country.

**In addition to reducing the opportunities for bribery, the problem can be addressed by more vigorous enforcement of antibribery laws and the activity of international organizations.** For example, the Hong Kong Independent Commission Against Corruption and the Corrupt Practices Investigation Bureau in Singapore are government-created units that have proven to be highly effective at uncovering and prosecuting instances of bribery.

### What actions are international organizations taking?

#### Other Examples

- A private NGO, Transparency International, consists of more than 90 chapters in countries around the world that seek, according to its website, “to promote transparency in elections, in public administration, in procurement and in business . . . [and] to use advocacy campaigns to lobby governments to implement anti-corruption reforms.”
- Highly visible tools of Transparency International are the annual “Corruption Perception Index,” which ranks countries on the perceived level of corruption, and the “Bribe Payers Index,” which ranks countries according to their willingness to restrict bribery by domestic companies.
- In 2003, the United Nations General Assembly adopted the “Convention Against Corruption,” which focuses on the prevention and criminalization of bribery and on international cooperation to combat it and recover plundered assets.

The most prominent examples of antibribery initiatives are the U.S. Foreign Corrupt Practices Act of 1977 (FCPA, amended in 1988) and the “Convention on Combating Bribery of Foreign Public Officials in International Business Transactions,” adopted by the countries of the OECD in 1997.

- The OECD convention commits each member country to change its laws to accord roughly with the FCPA. Specifically, OECD members, which include the world’s richest nations, have agreed to prohibit bribery of foreign officials, impose criminal penalties on those found guilty, and allow for the seizure of profits gained by bribery.
- Both initiatives concentrate on the “supply” side by changing the conduct of corporations that have been paying bribes.

**Table 14.2** Strategies for Combating Bribery

Identify the general strategy that describes each set of related tactics and goals for combating bribery in the two left columns. Show the cells to check your answers.

Anti-Bribery Tactic(s)	Goals	Strategy
Limit government involvement and promote free markets and healthy competition	Design and enforce proper regulations to clarify and simplify processes	Alter the government's role in the economy
Pay civil servants more to remove the need for extra income	Make civil service jobs so attractive that the risk of losing them will deter bribery	Reduce the temptation to demand or accept bribes
Carefully select projects to eliminate those most vulnerable to bribery	Closely monitor approved projects; have funding agencies and lending institutions perform checks	Eliminate bribery in government projects
Create special law enforcement units to uncover and prosecute instances of bribery	Promote international standards against corruption to combat bribery; use international cooperation to recover plundered assets	Focus on enforcing laws to prevent and criminalize bribery

Many observers are optimistic that the FCPA and the OECD convention will significantly reduce the incidence of foreign bribery and produce a more level playing field for all multinational corporations, but the evidence to date is not encouraging. The 2014 report by Transparency International on enforcement of the OECD convention concludes,

“creating a corruption-free level playing field for global trade is still far from being achieved.”<sup>50</sup>

Use Table 14.2 to review the various ways in governments can help companies make progress toward “corruption-free” international business.

**FOREIGN CORRUPT PRACTICES ACT (FCPA)** Since 1997, it has been against U.S. law for an individual or a company to bribe a foreign official for the purpose of obtaining or retaining business. The FCPA was enacted by Congress in part to protect American interests. The widespread use of slush funds to make payments during the 1970s raised fears that U.S. corporations were engaging in false financial reporting that compromised the integrity of securities markets. When the Securities and Exchange Commission encouraged the voluntary disclosure of foreign payments without fear of prosecution, more than 400 companies admitted to paying a total of \$300 million that was not fully accounted for in their books. In addition, Congress was concerned that foreign payments by American corporations were undermining the governments of friendly countries around the world and interfering in the conduct of U.S. foreign policy.

**PROVISIONS OF THE FCPA** The FCPA applies not only to American citizens and companies but also to certain foreign entities that conduct business in the United States. In addition to the prohibition of bribery, the Act contains an accounting section that requires companies to maintain financial records that accurately and fairly represent transactions in reasonable detail, including the amount and the purpose of all payments, and to develop a system of internal accounting controls sufficient to ensure that these records are accurately and fairly stated. A foreign official is

defined broadly to include not only government employees but also any person acting in an “official capacity,” and the Act also covers payments to political parties and candidates for office in foreign countries. The payment must be intended to induce a foreign official to violate a duty by misusing his or her official position in a way that confers some benefit to the bribing party. The law does not require that the payment be accepted or achieve its purpose; the mere offer or promise of a payment constitutes a violation of the Act.

The FCPA also prohibits payments through intermediaries or third-parties while knowing or having reason to know that any portion will be used to bribe foreign officials. Much business in foreign countries is conducted through intermediaries, who may pay bribes without the knowledge of the American firm. When American firms enter into joint ventures with foreign companies, they may have a similar lack of control over the conduct of their business partners and the maintenance of their books. Deliberately avoiding knowledge of an agent's activities is not an adequate defense, and so companies should take precautions to “know their agents.” Among the advised precautions are

- checking out the reputation of the agent and being sure that the agent has some genuine service to provide;
- paying the agent only an amount commensurate with the services provided and seeking an accounting of all expenses incurred;
- avoiding suspicious requests, such as depositing the money in a certain bank account; and
- obtaining a detailed agreement that includes a pledge not to violate the FCPA and the right to terminate the contract for any violation.

Certain kinds of payments are legally permitted and do not constitute bribes under the FCPA. These include “facilitating payments,” which are made to expedite the performance of “routine governmental action.” Also called “grease payments,” these are small sums paid to lower-level officials to lubricate the rusty machinery that

provides government services. Facilitating payments do not induce anyone to violate a duty. Still, they are generally prohibited by the same governments that create the need for them, although the laws on such matters are rarely enforced. Also excluded from the category of bribes by the FCPA are reasonable expenditures for legitimate expenses, such as entertaining a foreign official in the course of doing business. Finally, any payments that are permitted or required by the written laws of the country in question are legal under the FCPA. Although such payments might still be considered bribes, the drafters of the FCPA did not believe that individuals or corporations should be prosecuted in the United States for abiding by local laws elsewhere. The stipulation that the laws be written is designed to ensure that the payments are really legal and not merely customary.

For violations of the FCPA, which are prosecuted by the U.S. Department of Justice, corporations may be fined up to \$2 million and individuals may be fined up to \$100,000 and imprisoned for up to five years (and the fine for an individual may not be paid by the corporation).

**JUSTIFICATION OF THE FCPA** The justification for a legal prohibition on foreign bribery is rather straightforward. A double standard is employed if a country permits its companies to do abroad what they are forbidden to do at home. It has already been demonstrated not only that bribery is morally wrong but also that it severely harms economic development. The main arguments to the contrary are that bribery is necessary for doing business in some countries and that a country that prohibits its own companies from bribing places them at an unfair competitive advantage. Some have argued that the FCPA is a form of “ethical imperialism” that imposes our values on other countries.

These contrary arguments are not very persuasive.

- **First**, if foreign bribery is wrong, then the fact that America’s competitors around the globe practice it does not provide a justification.
- **Second**, American firms have been able to compete in many instances without bribing, in part by developing better products and services and marketing them aggressively. Anecdotal evidence suggests that bribery is involved in many contracts that U.S. firms fail to attain, but it is difficult to determine who would have obtained the award had there been a level playing field. No academic studies to date have documented substantial loss of business due to the FCPA.<sup>51</sup> Even if some loss of business has occurred, it must be weighed against the other benefits that led Congress to enact the FCPA. That is, is the United States as a nation better off for the passage of this act?
- **Third**, the FCPA is scarcely an instance of “ethical imperialism” just because it applies only to the

conduct of American firms. The immorality of bribery comes close to being a universal norm and is prohibited by laws in many countries, including the members of the OECD.

## 14.5: Human Rights Abuses

### 14.5 Relate the challenges multinational companies face in dealing with repressive governments, and how a strategy of constructive engagement can be applied to operations in countries with a record of human rights abuses

#### Case: Microsoft in Russia

As part of an aggressive effort to combat the unlicensed use of its popular software programs, Microsoft employs lawyers and cooperates with government agencies worldwide in systematic enforcement campaigns. In September 2010, the *New York Times* broke a story about how the police in Russia were using illegal, pirated software as a pretext for raiding advocacy groups and opposition newspapers and for carting off computers filled with critical documents.<sup>52</sup> In some cases, the targets of these raids had proper licenses for the software installed, and often charges of software piracy were never filed; but the disruption of activities and the cost of fighting the charges were enough to cripple their operations. Although software piracy is rampant in Russia, the *Times* article reported that the police “rarely if ever carry out raids against advocacy groups or news organizations that back the government.”

Microsoft lawyers were reported to work closely with the police, sometimes initiating investigations and defending the company as a victim of the criminal conduct, and some were accused of helping corrupt police to extort money from the targets of piracy investigations.<sup>53</sup> Although Microsoft executives denied that company lawyers initiated any investigations, they admitted that the lawyers had participated in them but only because their involvement was required by Russian law. The victims appealed to Microsoft for protection, and the Moscow Helsinki Group, an influential human rights watch organization, accused Microsoft of being complicit in “the persecution of civil society activists.”<sup>54</sup>

Initially, Microsoft responded to these charges and the damaging publicity by stressing its right to protect the company’s products from piracy and explaining how the company carefully selects, trains, and monitors its local lawyers and how it seeks to prevent individuals and organizations from falsely claiming to represent Microsoft.<sup>55</sup> Within a few days, Microsoft reversed course and announced new policies. A spokesperson declared, “We want to be clear that we unequivocally abhor any attempt to leverage intellectual property rights to stifle political advocacy or pursue improper personal gain. We are moving swiftly to seek to remove any

incentive or ability to engage in such behavior.”<sup>56</sup> Specifically, Microsoft announced that it had barred its lawyers from taking part in piracy investigations, was granting blanket software licenses to all advocacy groups and newspapers, and was providing legal aid to all victims of the piracy crackdown. These actions effectively undercut the legal basis for police action against groups opposed to the Russian government. However, Microsoft has yet to condemn the raids or criticize the Russian government for violations of human rights for fear of jeopardizing its ability to do business in the country.

The experience of Microsoft in Russia exemplifies the challenges faced by multinational corporations as they operate in countries with repressive governments that engage in massive violations of human rights. A few countries, one being Burma (also called Myanmar), are so repressive that many companies avoid them entirely, and the ones that operate there face international censure. No company can operate in such a country without giving substantial support to an utterly corrupt and brutal regime, and Burma earns Freedom House’s “absolute worst rating for political rights and civil liberties.”<sup>57</sup> In other countries, such as Russia, China, Nigeria, Indonesia, and Venezuela, it is possible for multinational corporations to conduct business ethically, albeit with some challenges.

#### Examples:

- Chrysler, which operates a Jeep plant in a joint venture with the Chinese government, was pressured in 1994 by the government to dismiss an employee, Gao Feng, a devout Christian, who had been arrested for planning a worship service and candlelight vigil on the fifth anniversary of the Tiananmen Square massacre.<sup>58</sup> After firing him for being absent during his interrogation in jail, Chrysler relented in the face of international criticism and reinstated his employment, following which he was arrested again and sent to a reeducation camp.
- In 1995, Royal Dutch/Shell, which produced oil in the Ogoniland region of Nigeria, became embroiled in controversy when the company was called upon to intervene to prevent the execution of Ogoni activist Ken Saro-Wiwa, who had criticized Shell’s environmental record and was convicted for murder in what was perceived as a kangaroo trial.

Multinational corporations must decide,

- First, whether to enter certain countries by making direct investments, selling products, or sourcing materials.
- Then, they must consider how to operate ethically, which, in the “Protect, Respect, and Remedy” framework, includes respecting human rights and remedying infringements.

The second kind of decision can generally be made in accord with the guidelines for multinationals discussed prior in this chapter.

Accordingly, this section addresses the first question of country selection. Is it ethical to operate in a country with a repressive government that engages in systemic human rights abuses? Furthermore, if a company engages, can it separate itself from any human rights abuses committed by the government or should it be held morally and legally liable for these abuses?

### WRITING PROMPT

#### Business and Politics

Explain the extent to which the conduct of a governing regime should influence a company’s decision to conduct business in other countries. When might such considerations take priority or compel a company to enter—or withdraw from—a country?

▶ The response entered here will appear in the performance dashboard and can be viewed by your instructor.

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## 14.5.1: Constructive Engagement

Is it ethical to operate in a country with a repressive government that engages in systemic human rights abuses?

Companies that operate in Burma and other “ethically challenging environments”<sup>59</sup> commonly defend themselves by describing their strategy as “constructive engagement.” The argument is that although human rights abuses do occur, the company, on the whole, is making a positive contribution that would not occur in its absence. Such a defense rests on utilitarian grounds of benefit or welfare, which may be strong, but it does not address the possible charge that a company may do some good but still be complicit in human rights abuses.

The success of a constructive engagement strategy depends on two factors:

- first, on the receptiveness of the government in a country to change and,
- second, on the commitment and effectiveness of a company with regard to such change.

Constructive engagement is a high-minded approach, filled with good intentions, but it is difficult to implement effectively. Progress is not easily documented, and the approach may serve as a convenient rationalization for “business as usual,” especially when there is no realistic hope for change and the company is insincere or ineffectual in seeking it. However, some effort may be preferable to unrestricted engagement, in which no attempt is made to be constructive.



Guidelines for constructive engagement are difficult to formulate since so much depends on the local context. For example, the original Sullivan Principles, drafted in 1977 to guide companies choosing to do business in apartheid-era South Africa, were focused mainly on equal treatment and improved conditions for black and colored employees. Later, a different set of Global Sullivan Principles was developed to provide more general guidance under all conditions.

John R. Schermerhorn suggests that companies doing business in a country such as Burma ought to adhere to the following basic principles.<sup>60</sup>

- Management control over all aspects of local operations, including labor practices, conditions of employment, and subcontracting.
- Management commitment to inviolable respect for human dignity, basic rights, and good citizenship in all aspects of local operations.
- Management control over local use of the corporate identity and brand names, including government-sponsored public relations and advertising.
- Management commitment to control revenue set-asides to improve conditions of life for local employees and broader citizenry, including housing, public services, education, and healthcare.
- Management confidence in the basic rights of local citizens to personal safety, freedom of movement, political participation, and economic advancement.
- Management commitment to annual and objective external audits of all aspects of local operations and to the public release of audit results.

*Non-engagement* occurs when a company chooses not to enter a certain country. Such a decision may be based solely on sound business considerations. Among these considerations are threats to a company's brand image and intellectual property, exposure of employees to risks of health and safety or human rights violations, and subjection of the company to risks from corruption and social and political instability that would impede normal operations. Alternatively, a company may decide for explicitly moral reasons not to engage. These reasons may include an incompatibility of particular environments with a company's mission or values or a commitment to support certain social causes, including organized boycotts such as the boycott in the 1970s designed to end apartheid in South Africa. For example, Robert Haas, the CEO of Levi Strauss, made the decision in 1993 to discontinue relations with suppliers in China and to defer any direct investment because of concern about pervasive violations of basic human rights. However, five years later, in 1998, Levi Strauss decided to resume sourcing in China and to sell clothing there.

## 14.5.2: Liability for Abuses

Should a company be held morally and legally liable for abuses committed by the government of a country in which it operates?

Although multinational corporations may rightly claim that they do not commit human rights abuses in countries where they operate, they may still have knowledge of and provide some resources for actions by a government that violates people's rights, and they may also be the intended beneficiary of the government's repression.

### Examples:

- Unocal, a U.S.-based oil company, committed to build a 256-mile pipeline to deliver natural gas from the Yadana field in Burma to a terminal in Thailand. During the construction, which occurred between 1993 and 1998, several human rights groups, including Greenpeace, Amnesty International, and Human Rights Watch, charged that the Burmese army was conscripting forced labor, relocating people without compensation, and brutally suppressing dissent. A consultant hired by Unocal in 1995 confirmed these charges.
- Also in the 1990s, Mobil Oil Company (now Exxon-Mobil) operated gas wells in the Aceh region of Indonesia, where the government was fighting local separatist rebels. It is alleged that Mobil provided buildings where villagers were tortured, raped, and executed; loaned heavy equipment such as excavators to dig mass graves; and paid the wages of soldiers who burned and pillaged homes in the surrounding area.

In each of these cases, the companies did not themselves actively commit these crimes, but they had some knowledge of the events (how much is disputed), provided not insignificant support (perhaps unwittingly), and received substantial benefits (willingly or not). If the allegations against Unocal and Mobil are true, then the companies are morally culpable of complicity in human rights abuses in accord with standard conditions for responsibility, which are the actions performed (what is done) and one's state of mind (knowledge and intent). Each company denies the allegations, but the guiding principles are clear.

Less clear is the legal right of victims of human rights abuses to seek remedy in court. Should foreign nationals have the right to bring suit against U.S. companies in American courts for human rights violations? Some victims from Burma and Aceh have sought to do so by means of a law, the Alien Tort Claims Act (ATCA), which was enacted by Congress in 1789 for reasons that remain murky. The ACTA states, "The district courts shall have

original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States.” The “law of nations” apparently refers to any wrongs that are generally prohibited in different legal systems, such as torture. Indeed, the law remained unused for 200 years before it was invoked to allow a suit against military officers from Paraguay, now living in the United States, by the family of a man they tortured to death.

Both the legal interpretation and the moral justification of the ATCA are in dispute. Many cases have wound their way through the courts with conflicting and inconclusive rulings, and debate is raging over the wisdom of allowing such suits in U.S. courts.<sup>61</sup> Legal questions about interpretation concern who has standing to sue and whether corporations or only individuals can be sued. Questions of moral justification tend to pit considerations of justice—whether victims of human rights abuses should not have some legal remedy in U.S. courts when American corporations are complicit—against practical concerns about how extensive liability might impact the ability of corporations to operate abroad or open them to frivolous law suits.

Some of these questions were addressed in 2013 when the U.S. Supreme Court ruled in a suit brought by several Nigerian citizens who claimed to be victims of human rights abuses by Shell Oil Company.<sup>62</sup> The unanimous decision to reject the suit appears to deny use of the ATCA by foreigners to seek redress for human rights violations in U.S. courts, except when national interests are sufficient to overcome a presumption against extraterritorial application of U.S. law. Whether those interests include a forum to redress human rights violations remains an open question.

### WRITING PROMPT

#### Justice for Victims

Should foreign nationals whose human rights have been violated by U.S. companies operating in their country have the right to sue those companies in American courts? What other options, if any, are open to these victims, assuming the legal system in their home country cannot help them?

► The response entered here will appear in the performance dashboard and can be viewed by your instructor.

Submit

## Conclusion: International Business Ethics

Operating abroad, especially in less-developed countries, creates dilemmas that lead to charges of serious ethical failings. Multinational corporations generally recognize a social responsibility and attempt to fulfill their responsibilities everywhere they are located. The major causes of occasional failures to act responsibly are not inattention and lack of effort but the diversity of political and legal systems around the world and differences in economic development. Foreign operations give rise to challenges—and also create opportunities for misconduct—that simply do not exist for purely domestic enterprises.

The main quandaries facing all MNCs are deciding which standards to follow and determining how to observe these standards. We have seen that neither of the two extreme positions on the choice of standards is satisfactory. The familiar adage “When in Rome, do as the Romans do” and the opposite, “When in Rome or anywhere else, do as you would at home,” are both inadequate guides. Instead, this chapter offers guidelines for developing and implementing special standards for the conduct of international business that can be applied to such matters as so-called sweatshops, foreign bribery, and human rights abuses. Ultimately, the solution for many of the ethical problems of international business lies in the development of

international agreements and codes of ethics. As the guidelines for multinational corporations become more detailed and comprehensive, the need for special standards of international business may diminish, and business conduct may eventually be the same worldwide.

## End-of-Chapter Case Studies

This chapter concludes with three case studies.

These three cases vividly demonstrate the obvious but critical point that multinational corporations encounter problems abroad that would not occur at home—or, if they did occur there, would be more easily handled. In “H.B. Fuller in Honduras,” a company with a stellar reputation for social responsibility is criticized for the tragic misuse of a major product. Not only is this misuse due to abject poverty in a developing country, but the resources necessary for addressing the problem, which would be available domestically, are not present abroad. A study of the blatant bribes paid by executives of Walmart’s Mexican subsidiary (“Walmart in Mexico”) is useful for exploring the factors that allowed this misconduct to occur in an otherwise reputable parent company, and also the

factors that contributed to the home office's inept handling of the subsequent investigation. "Google in China" presents the story of an ongoing challenge for the world's largest Internet company in the world's largest country. How Google manages to operate in a country that practices extensive censorship will affect not only the future of this iconic company itself but also millions of Internet users in a changing part of the world.

## Case: H. B. Fuller in Honduras

In 1985, journalists began writing about a new social problem in Honduras that created an acute dilemma for H. B. Fuller Company, based in St. Paul, Minnesota.<sup>63</sup> The news stories described the ravaging effects of glue sniffing among the street children of Tegucigalpa, the capital of Honduras, and other Central American cities. The drug of choice for these addicts was Resistol, a glue produced by a Honduran subsidiary of H. B. Fuller, and the victims of this debilitating habit were known, in Spanish, as *resistoleros*. The negative publicity was sullyng the company's stellar reputation for corporate social responsibility, and company executives came under great pressure to address the problem quickly.

### Background of the Problem

Poverty in Honduras had forced many families to send their children into the streets to beg or do odd jobs. The earnings of these children were critical to the support of many families, especially those headed by a single mother. Some children lived in the streets in order to avoid abusive homes; others were abandoned or orphaned. Many children, some as young as five or six, sought relief from their misery by sniffing glue containing volatile solvents that produce a temporary elation and sense of power. These chemicals are addictive and lead to irreversible damage to the brain and liver. The victims of solvent abuse generally stagger as they walk and exhibit tense, aggressive behavior.

Resistol is a brand name for a line of adhesives manufactured by a wholly owned subsidiary of H. B. Fuller and marketed throughout Latin America. The solvent-based adhesives favored by glue sniffers were widely used in shoemaking and shoe repair and were readily available on the street. H. B. Fuller had urged the press not to use the term "resistoleros" because other brands of adhesives were used as well and the problem was with the abuse of Resistol, not the product itself. Nevertheless, the name was commonly used in Honduras to describe the street children addicted to solvents. One of H. B. Fuller's most successful brands had thus become synonymous with a major social problem.

Criticism of H. B. Fuller for its involvement in this problem came not only from activists and public health

officials in Honduras but also from customers and shareholders in the United States. One shareholder asked, "How can a company like H. B. Fuller claim to have a social conscience and continue to sell Resistol, which is 'literally burning out the brains' of children in Latin America?" The company's mission statement placed its commitment to customers first, followed by its responsibilities to employees and shareholders. And the statement affirms: "H. B. Fuller will conduct business legally and ethically . . . and be a responsible corporate citizen." When the company acquired its subsidiary in Honduras, the CEO at the time said,

We were convinced that we had something to offer Latin America that the region did not have locally. In our own small way, we also wanted to be of help to that part of the world. We believed that by producing adhesives in Latin America and by employing only local people, we would create new jobs and help elevate the standard of living. We were convinced that the way to aid world peace was to help Latin America become more prosperous.

Company executives faced the dilemma of whether these expressions of H. B. Fuller's aspirations could be reconciled with the continued production of Resistol in Honduras.

### Addressing the Problem

In addressing the problem posed by the marketing of Resistol, the options for H. B. Fuller were limited. Community activists in Honduras proposed the addition of oil of mustard to all solvent-based adhesives. This chemical, allyl isothiocyanate, produces a reaction that has been compared to getting an overdose of horseradish. Adding it to Resistol would effectively deter anyone attempting to inhale the fumes. However, research revealed that oil of mustard has many side effects, including severe irritation of the eyes, nose, throat, and lungs, and it can even be fatal if inhaled, swallowed, or absorbed through the skin. In addition, adhesives with oil of mustard have a shelf life of only six months. H. B. Fuller executives were convinced that the addition of oil of mustard was not an acceptable solution. However, in 1989, the Honduran legislature passed a law requiring oil of mustard, despite the lobbying efforts of H. B. Fuller.

Another alternative was a community relations effort to alert people about the dangers of glue sniffing and to address the underlying social causes. By working with community groups and the government, the company could spread the responsibility and expand its resources. On the other hand, the community groups in Honduras and elsewhere in the region were not well organized, and the government was unstable and unreliable. In 1982, the Gillette Company had faced a similar problem with its solvent-based typewriter correction fluid, Liquid Paper,

which was being abused by youngsters in the United States. Gillette also rejected the possibility of adding oil of mustard, but the company's community relations effort was facilitated by the existing network of private and government-sponsored drug education programs. In Honduras, H. B. Fuller did not have the same base of community and government support. A community relations effort would be much more difficult in a less-developed country.

H. B. Fuller executives also considered withdrawing all solvent-based adhesives from the market and perhaps substituting water-based products, but these alternatives were not very attractive from a business point of view. Furthermore, they would have no impact on the critical social problem of glue sniffing by street children. The waste of young lives would continue unless conditions were changed. But what could a modest-sized company located in St. Paul, Minnesota, do to address a problem caused by deep cultural, social, political, and economic forces? A failure to act, however, would seriously damage H. B. Fuller's carefully built reputation for corporate social responsibility.

#### SHARED WRITING: H. B. FULLER IN HONDURAS

What should H.B. Fuller do in order to "do more good than harm" in Honduras? Explain which of the following actions the company should take in order to sufficiently address the problem, or describe alternatives:

- Add the mustard oil to the glue, as required by Honduran law
- Support community efforts to alleviate the plight of street children
- Stop the sale of Resistol in Honduras altogether, in order to make it inaccessible to street children

Review and comment on at least two classmates' responses.

▶ **A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.**

Post

0 characters | 140 minimum

## Case: Walmart in Mexico

Walmart became a household name in Mexico in 1991 when Walmart Stores, Inc., headquartered in Bentonville, Arkansas, entered into a joint venture with the longtime Mexican retail firm Cifra. This joint venture led to the opening of new stores under the names Walmart and Sam's Club, along with Cifra's Superama and Bodega Aurrerá outlets. Walmart purchased Cifra in 1997, creating Walmart de Mexico, which eventually became the largest employer in Mexico with more than 209,000 workers across 2,200 stores. By 2014, one-fifth of all Walmart stores

worldwide were located in Mexico.<sup>64</sup> Throughout 2003, Mexican managers of the retail giant Walmart pursued an aggressive plan to open a new store in the city of Teotihuacán on land that was not zoned for commercial development. Teotihuacán (pronounced tay-o-tea-wah-KHAN) boasts some of Mexico's most significant remnants of the ancient Aztec civilization, and many parts of the city remained protected for cultural and archeological reasons. Resisting Walmart's concerted efforts to change the applicable zoning ordinance, Teotihuacán's city council voted on August 6, 2003, to reaffirm a ban on commercial development in the proposed area.<sup>65</sup>

## Gaining Approval

Surprisingly, on August 20, 2003, the state Office of Urban and Regional Planning, which certified and published cities' zoning proposals, made an unexpected and apparently unauthorized revision to Teotihuacán's zoning map that designated the land in question as eligible for commercial use. Walmart neither made a formal request for this last-minute change nor petitioned the state planning office to alter the map. However, in the days between the city council's vote and the state planning office's revision, Walmart managers in Mexico displayed a confidence that the development would proceed by undertaking environmental assessments of the area, obtaining approval for additional construction funding, and seeking building permits. Internal Walmart records show that Sergio Cicero Zapata, a high-level real estate manager in the company's Mexican subsidiary, authorized a payment of \$52,000 on the day after the Office of Urban and Regional Planning formally published the altered version of Teotihuacán's zoning map.

According to Cicero, the intended recipient of that payment was the director of the state planning office, who was responsible for publishing an official record of a city's zoning decisions. Around the same time, further payments were authorized by Cicero that enabled the construction of Walmart's store in Teotihuacán, including \$114,000 to the mayor of Teotihuacán to secure building licenses, road construction permits, and certification that the land was free from archaeologically sensitive artifacts. Eventually the store in Teotihuacán was built, and it remained open, despite vocal resistance from community activists and members of the city council.<sup>66</sup>

The development of Walmart's Teotihuacán store has been revealed to be only a small part of a systematic effort within its Mexican operations to secure favorable treatment on many matters by bribing government officials.<sup>67</sup> Investigations by journalists and by Walmart officials in the United States in response to news stories also prompted reviews by the U.S. Department of Justice and the Securities and Exchange Commission on whether Walmart

violated the anti-bribery provisions of the Foreign Corrupt Practices Act (FCPA) during the early- to mid-2000s.<sup>68</sup>

Bribery in Walmart's Mexican operations was sophisticated and well-organized. Alarmed by what he had observed, Cicero initially reported the company's use of bribes to Walmart executives in the United States to expose what he considered to be significant wrongdoing. He emailed Walmart's general counsel for international operations, Maritza Munich, on September 21, 2005, and identified specific practices that he and other Walmart de Mexico officials routinely used to secure bureaucratic actions in the company's favor.<sup>69</sup> These included permissions by local zoning boards and city councils, successful environmental impact assessments, and, in some cases, expedited construction and land use permits. Such special treatment was instrumental in receiving timely legal authorization to open new stores as part of its aggressive expansion plans. Central to Cicero's allegations was that the top leaders at Walmart de Mexico, including the chief executive, Eduardo Castro-Wright, and general counsel, José Luise Rodríguezmacedo Rivera, had authorized irregular payments, which were believed to have totaled more than \$16 million between 2003 and 2005 and almost \$24 million in total since the formation of Walmart de Mexico.<sup>70</sup>

### How were the bribes conducted?

#### Cicero was part of this strategy

It was his job to cultivate relationships with well-placed, highly trusted individuals within the communities where Walmart de Mexico was seeking to build stores. Those individuals were known as *gestores*, agents who help others to successfully navigate Mexico's byzantine bureaucracy. Cicero recruited *gestores* to arrange and subsequently deliver bribes on behalf of Walmart. Cicero reported to Munich that he would provide envelopes of cash to *gestores* who subsequently handed the money to mayors, city council members, and other bureaucrats to do Walmart's bidding. The *gestores* would submit invoices that covered the bribe payments as well as their fees, which were typically 6 percent of the bribe amounts paid. These invoices used special terminology to disguise the nature of the payments. Bribes were recorded for accounting purposes as innocuous fees for services or permits.<sup>71</sup>

After Cicero's initial disclosure, Munich urged executives in Arkansas to begin an investigation. Following standard FCPA-prescribed practices, Walmart maintained a strict anti-corruption policy that prohibited any employee from offering anything of value to a government official on behalf of Walmart. Munich initially appointed a Mexican attorney to investigate the allegations of bribery. In addition to notifying Michael Duke, vice chairman of Walmart in charge of international operations and later to become

CEO, Munich sent memos to Walmart's executive vice president and senior internal auditor, as well as to the chief executive officer, H. Lee Scott, regarding what she perceived to be credible evidence that bribery was practiced at the highest levels of management in Walmart de Mexico. Rather than hiring a law firm with expertise in FCPA compliance to lead an investigation, executive leadership at Walmart opted to conduct an internal inquiry led by Walmart's own lawyers in conjunction with the company's corporate investigations unit.<sup>72</sup> Shortly before this decision, the chief executive of Walmart de Mexico, Castro-Wright, was promoted to vice chairman of Walmart's U.S. operations.

Within one day, the lead investigators uncovered evidence confirming hundreds of cases where *gestores* were paid tens of thousands of dollars to secure permits. Two *gestores* alone received payments totaling \$8.5 million.<sup>73</sup> These payments not only coincided with Castro-Wright's tenure at Walmart de Mexico but also mirrored periods of growth in which new stores were built. They also discovered that Walmart de Mexico's own auditors had previously notified Castro-Wright and Rodríguezmacedo about possible violations of American and Mexican anti-bribery laws. However, the same auditors claimed that Rodríguezmacedo edited their reports to remove information materially relevant to Walmart de Mexico's legally questionable activities. This editing effectively kept officials at Walmart headquarters ignorant of the bribery taking place in Mexico.

## Criticizing the Investigation

In late 2005, the new chief executive of Walmart de Mexico, Eduardo Solórzano Morales, was openly critical of the ongoing corporate investigation being coordinated from the Bentonville headquarters, stressing that the investigators were secretive, too aggressive in their interviews, and insensitive to the business culture of Mexico. In response, Walmart leaders, including CEO Scott, held a meeting on February 3, 2006, to reorganize the investigation unit's bribery probe in Mexico. A new company policy was developed that placed greater responsibility for investigations on Walmart subsidiaries. This effectively meant that the company's investigation into bribery by Walmart de Mexico was now largely under the direction of Rodríguezmacedo, the same general counselor who was initially suspected of involvement in the Mexican bribe payments. The fact that Rodríguezmacedo was now formally leading the investigation of alleged bribery in Mexico was clearly in conflict with the practices prescribed by Walmart's own ethics and compliance office, which recommended that "investigations should be conducted by individuals who do not have any vested interest in the potential outcomes of the investigation."<sup>74</sup> Yet, it was Rodríguezmacedo who

wrote a final report of the Mexican inquiry, which concluded “there was no evidence or clear indication of bribes paid to Mexican government authorities with the purpose of wrongfully securing any licenses or permits.”<sup>75</sup> His six-page report remained silent on his involvement and that of other executives in expunging prior audits of payments to *gestores*. The report recommended that managers no longer use *gestores* and that the parent company make a renewed commitment to its anti-corruption policy.

In late 2011, upon learning of an upcoming story in the *New York Times* that would provide damaging details of the investigation, Walmart eventually disclosed the information it had gathered about bribery within its Mexican operations. Its attorneys and compliance officers met with the U.S. Department of Justice and the Securities and Exchange Commission to “self-disclose” its knowledge of possible violations of the FCPA.<sup>76</sup> This decision was accompanied by a press release describing Walmart’s new anti-bribery efforts, including the formation of a new FCPA compliance director within its Mexican subsidiary, updated training procedures for its employees, more robust internal accounting controls, and regular reporting to the audit committee of the company’s board of directors on matters related to its ongoing bribery investigation.<sup>77</sup> By 2104, Walmart had spent almost \$440 million on FCPA-related internal investigations of its Mexican operations and was facing shareholder lawsuits for the negligent oversight of its Mexican subsidiary.<sup>78</sup>

#### SHARED WRITING: WALMART IN MEXICO

Was Walmart led astray by the corrupt business culture in Mexico, or did the company take advantage of it? How might one justify Walmart’s decision to keep the results of its internal investigation confidential until 2011? What was the parent company hoping to achieve by handing the investigation over to Walmart de Mexico and the same general counsel who had approved the bribes in the first place?

Review and comment on at least two classmates’ responses.

▶ **A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.**

Post

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## Case: Google in China

At a congressional hearing on February 15, 2006, a Google executive sat with representatives from Microsoft and Cisco as their companies were charged with violating human rights in China. One member of Congress declared,

“It is astounding that Google, whose corporate philosophy is ‘don’t be evil’, would enable evil by cooperating with China’s censorship policies just to make a buck.” He continued, “Many Chinese have suffered imprisonment and torture in the service of truth—and now Google is collaborating with their persecutors.”<sup>79</sup> Another congressman complained, “Instead of using their power and creativity to bring openness and free speech to China, they have caved in to Beijing’s outrageous but predictable demands, simply for the sake of profits. . . . They enthusiastically volunteered for the Chinese censorship brigade.”<sup>80</sup> What had Google done to receive such criticism?

## Entering China

After its founding in 1998, Google quickly became a leading provider of web-based services on the strength of its popular search engine Google.com. With a mission “to organize the world’s information and make it universally accessible and useful,” the founders deliberately set about to build an unconventional company. In the Registration Statement filed when the company went public in 2004, the founders, Larry Page and Sergey Brin, said that their goal was “to develop services that significantly improve the lives of as many people as possible,” and they explained that the slogan “Don’t be evil” was intended to convey the belief that in the long term, Google employees and its shareholders will be better served “by a company that does good things for the world even if we forgo some short-term gains.”<sup>81</sup>

In an effort to bring the benefits of its search engine to China, a land of 1.3 billion people with an estimated 110 million Internet users, Google created in 2002 a Chinese-language home page, similar to the home pages in other languages that appear when the location of a computer is recognized by the website. Because Google’s servers were located outside China, the website was not subject to any Chinese legal restrictions. Google searches were completed just as they would be if the site were accessed in any other country. However, the Internet entered China through fiber optic cables that ran through nine licensed international Internet service providers. This control of the physical pathways of the Internet enabled the Chinese government to filter signal transmissions in and out of the country. When Chinese users requested searches on sensitive topics, such as the Tiananmen Square protests of 1989, Tibet, or the banned group Falun Gong, screens would go blank, error messages would appear, or else the connection would be diverted to government-approved websites free of any objectionable content. Because of the filtering—known as the “Great Firewall of China”—access to Google in China was slow and unreliable, but a great deal of information was still available.

## Trouble Develops

On September 3, 2002, Google vanished entirely from computer screens across China. The Chinese government had blocked all access. Although service was restored two weeks later, the intensity of filtering appeared to have increased. Google executives eventually realized that the company could not fulfill its mission without a presence in China. Other American companies, including Yahoo! and Microsoft already had operations in the country, and Google was losing market share not only to these domestic competitors but also to Chinese start-ups. The local company Baidu increased its market share from less than 3 percent in 2003 to 46 percent in 2005, while Google's share was 30 percent and falling.<sup>82</sup> In late 2004, Google undertook an assessment of its strategy in the Chinese market by consulting with Chinese Internet experts and users, human rights activists, government officials, and business leaders. According to a Google executive,

From these discussions, we reached the conclusion that perhaps we had been taking the wrong path. Our search results were being filtered; our service was being crippled; our users were flocking to local Chinese competitors; and, ultimately, Chinese Internet users had less access to information than they would have had.<sup>83</sup>

On January 27, 2006, Google launched Google.cn, a China-based website. In order to operate in China, the company had to obtain a license that committed it to observe Chinese laws and regulations, which required that a licensed Internet company censor its own content. Google explained its decision as a matter of balancing its commitment to its users and its own mission:

The requirements of doing business in China include self-censorship—something that runs counter to Google's most basic values and commitments as a company. Despite that, we made a decision to launch a new product for China—Google.cn—that respects the content restrictions imposed by Chinese laws and regulations . . . . [O]ur decision was based on a judgment that Google.cn will make a meaningful—though imperfect—contribution to the overall expansion of access to information in China.<sup>84</sup>

## Living with Censorship

Abiding by Chinese laws and regulations was not an easy matter, though. Censorship in China did not operate by clear and specific guidelines about what is and is not permitted. Instead, a climate of intimidation was created by vague rules that were enforced in an unpredictable but harsh manner. Prohibited content included material that “damages the honor or interests of the state” or “disturbs the public order or destroys public stability” or “infringes

upon national customs and habits.”<sup>85</sup> Moreover, censorship was enforced by numerous state agencies with overlapping authority, and the material considered objectionable changed frequently. The intended effect was to make Internet services use their own judgment about what content to allow. In order to know the permissible limits, Google developed its own list of forbidden words and topics by testing the Chinese filtering system and noting what content was blocked.

In developing Google.cn, the company followed three key principles.

- First, Google resolved to notify users when search results had been removed. In this way, the act of filtering was made transparent.
- Second, the private information about users was not collected so that the company could not be compelled to disclose it to the government. As a result, Google made the decision not to offer e-mail or blog sites in China, which had led to difficulties for other American companies. Yahoo!, for example, had been criticized for acceding to government demands that it disclose e-mail records, which enabled authorities to learn the identity of two dissidents, who were subsequently tried and sentenced to prison terms.
- Third, the Chinese version of Google.com continued to be available in addition to Google.cn, so that Google.cn would only expand the information available to Chinese users and not reduce it in any way.

Some critics complained that these measures were not enough. In particular, the notification to users that content had been blocked did not disclose the nature of the content. One dissident complained that the user could no longer tell what was being blocked: “It was one thing when you hit on links that did not work. You could see what was blocked. The new Google hides the hand of the censor.”<sup>86</sup> On the other hand, many Chinese users were becoming more savvy about hiding their tracks by using proxy servers and anonymizer programs and getting around the Great Firewall of China to access foreign material. Information and software for using the Internet were spread by “hactivists” working outside China.<sup>87</sup> So Google's self-censorship would have less effect on the ability of users to benefit from the Internet.

Moreover, Google was not alone in enabling the censorship of the Internet in China. Cisco and Microsoft had provided the hardware and software that sat atop the fiber optic cables at the border that conducted the filtering. And Google is not the only web information source faced with the question of whether to enter China. The operators of Wikipedia have been urged by Chinese users to create a version of the online encyclopedia that would

be acceptable to Chinese authorities.<sup>88</sup> All of Wikipedia has been blocked in China. The activists argue that 99.9 percent of the encyclopedia would remain intact after self-censoring and that access to all of this information would be of great benefit to the Chinese people. However, Wikipedia, like Google, is founded on the principle of uncensored information.

Google's leaders believed that given the choice of staying out of China and going in under the conditions imposed by the Chinese government, they made the right decision, one in keeping with the company's own mission and principles. As one executive explained, "Don't be evil" is "an admonition that reminds us to consider the moral and ethical implications of every single business decision we make. We believe that our current approach to China is consistent with this mantra."<sup>89</sup>

### SHARED WRITING: GOOGLE IN CHINA

Google eventually ended its self-censorship in China by shutting down its local servers and redirecting users to its uncensored services in Hong Kong. The Chinese government continues to censor and periodically restrict or block Google services and content in the mainland—to the frustration of international businesses, journalists, activists, and local students and academics. Decide whether it makes sense for Google to continue trying to provide free access to information and expand in China, having already tried the path of compromise, and explain your view.

Review and comment on at least two classmates' responses, including one that opposes your own.



A minimum number of characters is required to post and earn points. After posting, your response can be viewed by your class and instructor, and you can participate in the class discussion.

Post

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### Chapter 14 Quiz: International Business Ethics



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## Chapter 1

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## Chapter 4

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## Chapter 5

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  25. Food Quality Protection Act of 1996, Public Law No. 104–170, 110 Stat. 1489 (1996).
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  29. W. Kip Viscusi, *Risk by Choice* (Cambridge, MA: Harvard University Press, 1983), 80.

30. The following argument is adapted from Norman Daniels, "Does OSHA Protect Too Much?" in *Moral Rights in the Workplace*, 51–60.
31. Robert Nozick, "Coercion," in *Philosophy, Science and Method*, ed. Sidney Morgenbesser, Patrick Suppes, and Morton White (New York: St. Martin's Press, 1969).
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38. This exception suggests a further argument for the right to know based on fairness. Employers who knowingly place workers at risk are taking unfair advantage of the workers' ignorance. See McGarity, "The New OSHA Rules and the Worker's Right to Know," 40.
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40. Wendy W. Williams, "Firing the Woman to Protect the Fetus: The Reconciliation of Fetal Protection with Employment Opportunity Goals under Title VII," *Georgetown Law Journal*, 69 (1981), 641–704, 659–60.
41. Gail Bronson, "Issue of Fetal Damage Stirs Women Workers at Chemical Plants," *Wall Street Journal*, 9 February 1979.
42. "Company and Union in Dispute as Women Undergo Sterilization," *New York Times*, 4 January 1979; "Four Women Assert Jobs Were Linked to Sterilization," *New York Times*, 5 January 1979; Philip Shabecoff, "Job Threats to Workers' Fertility Emerging as Civil Liberties Issue," *New York Times*, 15 January 1979; and Bronson, "Issue of Fetal Damage Stirs Women Workers at Chemical Plants."
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46. Equal Employment Opportunity Commission and Office of Federal Contract Compliance Programs, "Interpretive Guidelines on Employment Discrimination and Reproductive Hazards," *Federal Register*, 1 February 1980, 7514.
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49. These examples are cited in Lois Vanderwaerd, "Resolving the Conflict between Hazardous Substances in the Workplace and Equal Employment Opportunity," *American Business Law Journal*, 21 (1983), 157–84.
50. The Supreme Court did not consider the business necessity defense, because only the BFOQ defense was held to be applicable in this case. The reason for not considering the business necessity test is that the fetal protection policy adopted by Johnson Controls was judged by the Court to be *disparate treatment*, which is to say that a distinction was made explicitly on the basis of sex, and disparate treatment discrimination requires the more demanding BFOQ defense. The weaker business necessity defense is applicable only to *disparate impact* discrimination, in which a policy not discriminatory on its face still serves to exclude protected groups disproportionately.
51. *Western Airlines v. Criswell*, 472 U.S. 400 (1985).
52. For the sake of simplicity, the discussion in this section focuses only on manufacturers, but a responsibility for product safety extends to wholesalers, distributors, franchisers, and retailers, among others, although their responsibility is generally less than that of manufacturers.
53. The conditions under which a negligent act is a cause of injury to another person (known in law as proximate cause) are complicated. See any standard textbook on business law for an explanation.
54. *Larsen v. General Motors Corporation*, 391 F.2d 495 (8th Cir. 1968).
55. *LeBouef v. Goodyear Tire and Rubber Co.*, 623 F.2d 985 (5th Cir. 1980).
56. See Ed Timmerman and Brad Reid, "The Doctrine of Invited Misuse: A Societal Response to Marketing Promotion," *Journal of Macromarketing*, 4 (Fall 1984), 40–48.
57. *Commercial National Bank of Little Rock, Guardian of the Estate of Jo Ann Fitzsimmons v. General Motors Corporation*, U.S. Dist. Ct. E.D.Ark., No. LR-C-79-168 (1979).
58. *United States v. Carroll Towing Co.*, 159 F.2d 169 (2nd Cir. 1947).
59. *Bashada v. Johns-Manville Products Corp.*, 90 N.J. 191, 447 A.2d 539 (1982). The "state-of-the-art" defense has been accepted in other cases. See, for example, *Boatland of Houston, Inc. v. Bailey*, 609 S.W.2d 743 (Tex. 1980). For an overview, see Jordan H. Leibman, "The Manufacturer's Responsibility to Warn Product Users of Unknowable Dangers," *American Business Law Journal*, 21 (1984), 403–38.
60. *Henningsen v. Bloomfield Motors, Inc. and Chrysler Corporation*, 161 A.2d 69 (1960).
61. *MacPherson v. Buick Motor Company*, 217 N.Y. 382 (1916).
62. *Baxter v. Ford Motor Company*, 168 Wash. 456, 12 P.2d 409 (1932); 179 Wash. 123, 35 P.2d 1090 (1934).
63. *Greenman v. Yuba Power Products*, 59 Cal. 2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1963). The theory was enunciated 19 years earlier in *Escola v. Coca-Cola Bottling Co.*, 24 Cal. 2d 453, 150 P.2d 436 (1944).
64. *Escola v. Coca-Cola Bottling Co.*
65. Richard A. Epstein, *Modern Products Liability Law* (Westport, CT: Quorum Books, 1980), 27. Epstein holds, however, that this principle has limited application in product liability cases.
66. George P. Fletcher, "Fairness and Utility in Tort Theory," *Harvard Law Review*, 85 (1972), 537–73; Richard A. Epstein, "A Theory of Strict Liability," *Journal of Legal Studies*, 2 (1973), 151–204; and Jules L. Coleman, "The Morality of Strict Tort Liability," *William and Mary Law Review*, 18 (1976), 259–586. Richard Posner argues that the Aristotelean principle of compensatory justice in a negligence system, correctly understood, is the same as the principle of efficiency that underlies strict liability. See Richard Posner, "A Theory of Negligence," *Journal of Legal Studies*, 1 (1972), 29–96; and Richard Posner, "The Concept of Corrective Justice in Recent Theories of Tort Law," *Journal of Legal Studies*, 10 (1981), 187–206.
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69. "What Is HNPP?" <http://www.hnpp.org/whatis.htm>.
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71. David Rubenstein, "Burlington Northern Discovers a Third Rail: Burned by a Genetic Test," *Corporate Legal Times*, July 2001, 68.
72. *Ibid.*
73. Darryl van Duch, "EEOC Goes after Genetic Testing," *National Law Journal*, 7 May 2001.

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  77. This case is adapted from David Zivan, "The Playskool Travel-Lite Crib," Center for Design Research, University of Chicago, 5 November 2002, with permission. This document, which is in the public domain, may be downloaded from <http://www.chicagocrd.org>. Much of the content of the case is taken from *Linda Ginzel, as independent administrator of the estate of Daniel Keysar, deceased, and on behalf of Boaz Keysar, Ely Keysar, and Linda Ginzel, next of kin, plaintiff, v. Kolcraft Enterprises, Inc., and Hasbro, defendants*, #98L7063, Circuit Court of Cook County, County Department Law Division.
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