ETHICS IN CONTRACTING: A GUIDE FOR THE PERPLEXED, and A BRIDGE FOR THE FUTURE

DON MAYER

ARSHT VISITING ETHICS SCHOLAR
UNIVERSITY OF MIAMI
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INTRODUCTION

Contracts: The Center of all Economic Activity
See powerpoint slide # 2

A "Good Contract?" – Sam Colt's Moral Dilemma[1]

Sam Colt is a sales representative working for Midwest Hardware, which manufactures – among other things – nuts and bolts. Sam wants to make a big sale to a construction firm (Greggo and Farrara, Inc.) that is building a new bridge across the Mississippi River near St. Louis. The bolts manufactured by Midwest hardware have a 3% defect rate; although this is acceptable in the industry, it does make them unsuitable for use in certain kinds of projects, such as those that may be subject to sudden, severe stress.

The new bridge will be located near the New Madrid fault line, the source of the United States' greatest earthquake, back in 1811. The epicenter of the earthquake, which caused extensive damage and altered the flow of the Mississippi, is less than 200 miles from the site of the new bridge. Earthquake experts believe there is a 50% chance that an earthquake with a magnitude greater than seven on the Richter scale will occur somewhere along the New Madrid fault by the year 2020.

Bridge construction in this area is not regulated by earthquake codes. This means that the contractor is not likely to require earthquake-resistant bolts in the bridge,

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[1] This case is borrowed from page 153 of your text, with some additions. This case may not be copied, re-used or transmitted, as the copyright is owned by Ferrell and Fraedrich. Use in this lecture and this handout is based on the "fair use" exception to copyright laws.

because no government inspector will require them. If Sam wins the sale, he gets a commission of $45,000 on top of his regular salary. If he tells contractor about the defect rate, Midwest is likely to lose the sale to a competitor. The competitor, Mississippi Fasteners, also manufactures bolts that are suitable for the bridge project, bolts that have a much lower failure rate under stress, and they are only slightly more expensive. The bolts can be acquired by the contractor for approximately $200,000 from Midwest Hardware. The price from Mississippi fasteners would only be slightly more, at $210,000.

Sam is meeting with a representative of the contractor, and wonders if he needs to tell the truth, the whole truth and nothing but the truth. Because of the possible bonus, he is hoping there is some ethical justification for not disclosing the defect rate of his company's bolts. He is aware that the contractor might ask, but that, given time pressures, the general good reputation of Midwest hardware, and the lack of regulation, the contractor is not likely to ask. Before he travels to St. Louis for the meeting, his boss, Bobby Dykes, tells him: "Don't blow this Sam; the company really needs this business. We're counting on you." Sam makes no promises, but says merely, "I know we need the business, boss."

MORAL PHILOSOPHIES = ETHICAL PERSPECTIVES

Moral philosophies and values influence how courts look at contracts. They will also influence the way <u>you</u> look at the contracting process, the free market, and how to do "good business." Using the materials from the second chapter in your textbook (Chapter 6), these materials review some basic concepts about contracting, ethical perspectives, and what it means to do "good business."

"CORPORATE SOCIAL RESPONSIBILITY," BUSINESS, AND MARKETS

Friedman on Maximizing Shareholder Wealth

<u>Milton Friedman</u>. See page 151 of <u>Introduction to Business Law</u>.

Paraphrased, your text tells us that the Nobel Laureate says: <u>profit</u> is the ultimate goal of the enterprise, and that business organizations do not need to concern themselves with the impact of their firms' decisions on society. This should be amended slightly; in his famous 1971 New York Times Magazine article, Prof. Friedman says: "there is one and only one social responsibility of business: to use its resources and engage in activities designed **to increase its profits as long as it stays within the rules of the game, which is to say, engages in open and free competition without deception and fraud.**"[2] What follows is an extract from other parts of that article.

What does it mean to say that "business" has responsibilities? Only people can have responsibilities. A corporation is an artificial person and in this sense may have artificial responsibilities, but "business" as a whole cannot be said to have responsibilities, even in this vague sense. . . .

Presumably, the individuals who are to be responsible are businessmen, which means individual proprietors or corporate executives. . . .

In a free enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be **to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom** . . . .

. . . the manager is that agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them. . .

Of course, the corporate executive is also a person in his own right. As a person, he may have other responsibilities that he recognizes or assumes voluntarily—to his family, his conscience, his feeling of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job . . . But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are "social responsibilities," they are the social responsibilities of individuals, not of business.

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

[2] Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," New York Times Magazine, Sept. 13, 1970.

must mean that he has 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 or 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 . . .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.

This process raises political questions on two levels: principle and consequences. On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. **We have established elaborate constitutional, parliamentary, and judicial provisions to control these functions, to assure that taxes are imposed so far as possible in accordance with the preferences and desires of the public . . .**

[Note: parts in bold, above, will be discussed below.]

So, please notice some very important premises, both explicit and implicit, in Friedman's approach. First, he assumes that there are rules of the game set by an impartial and effective public authority (elaborate provisions to assure public desires and preferences). Second, as an economist, he would as a matter of embracing his own discipline believe in efficient markets and the basic principles of efficient markets. Third, he also warns against businesses using fraud or deceit in the transactions. Fourth, he seems to embrace what is generally referred to as a "social contract," in saying that there are societal rules embodied in both "law and ethical custom." I would point out that these are very important conditions, and do not point to the usual (and erroneous) "takeaway" from Friedman, which is that if everyone and every business just tries to maximize short-term profit, all will be well. Let's start with his point about deceit. The points about public goods, economic principles, and social contract will be addressed later on.

Deceit comes in many forms, and we will have a chance to explore some of these forms. Prof. Friedman does not give us examples, but it seems fair to assume that he would not approve of one-party tricking another party to a contract, of holding back material information, or exploiting any number of factors that would undermine the paradigm of free-market transactions: a free, knowing, rational, voluntary and consensual exchange by two parties.

This is what makes capitalism such a good system for generating creative innovation: free, rational, voluntary exchanges, unfettered by excessive regulatory interference. But what we see when we look at our contracts cases is human nature at work, sometimes at its best, but more often at its worst, with parties trying to "game" the contracting process by using deceit, manipulation, power imbalances, appeals to emotions, and anything else that will make money. This is why the "rule of law" is needed to curb some of the over-reaching and egoism at the heart of many cases in your text.

Friedman is known as a great defender of capitalism. Speaking of capitalism, that "father of modern capitalism," Adam Smith (Wealth of Nations, Theory of Moral Sentiments) is also noted in your text on page 151. It does seem accurate to say that Smith would not have envisioned a few companies gaining control over the great majority of the worlds resources, and that he did not take full account "the immense wealth and power some firms wield within countries." We will have occasion to look at this below. (See Contracts, Corporate Social Responsibility, and Capitalism, p. __________)

Stakeholder Theory

Responding to Friedman, many have challenged the notion that corporate managers have no real duties except toward the owners (shareholders). A stakeholder is anyone who is significantly affected (positively or negatively) by the decision of another moral agent. A corporation's management clearly owes duties to shareholders; change two letters in shareholder, and you get "stakeholder." These non-shareholder stakeholders of a corporation include its employees, suppliers, customers, and the community. Stakeholder theorists contend that a corporation, through its management, also has a set of responsibilities toward these non-shareholder interests, the very point that Friedman was contesting in his article.

We will come back to stakeholder theory in due time. (See below, pp. _____)

ETHICAL PERSPECTIVES - GENERALLY

Let us now look at the ethical perspectives noted in table 6 -1 at page 153, and categorize them as follows:

Standard ethical perspectives

utilitarianism
deontology
virtue ethics
justice

Other ethical perspectives(not noted in the text)
social contract
rights and responsibilities (communitarianism)

Questionable ethical perspectives
teleology
relativism
egoism

We will start with the questionable category, look at standard ethical perspectives, and discuss social contract and communitarianism.

Questionable Ethical Perspectives

Egoism is generally understood to be the attribute and expression of self-interest, and so is not a perspective generally regarded as "ethical."

Suppose you know John, and Sarah says, "John only thinks of himself. As in, all the time!" If that is true, most people would agree that John is not really capable of ethical thought, much less action. Kohlberg (see pages 166 - 167) would agree: John is totally pre-conventional. He knows what he wants, but his orientation is always about himself. Either he is going to do whatever he can get away with (avoiding punishment, as in Stage 1) or, at stage 2 (still pre-conventional), he will engage others in "I'll scratch your back if you scratch mine" transactions, where others are seen as <u>a means to his own ends</u>. (As Kant would say, these others have instrumental value only, and are not being respected as persons in their own right.)

As the book notes, many people believe that egoistic people and companies are inherently unethical, or short-term oriented, and will take advantage of any opportunity. I concur. Egoism as such has no claim to be an ethical approach to decision-making.

<u>Relativism</u> is not much better as an ethical approach. Relativism usually adopts the belief that there is no objective way to make reasonable judgments about better and worse behavior. As the book points out, relativism places too much emphasis on people's differences while ignoring the basic similarities. Placing undue emphasis on differences among people can lead to the erroneous conclusion that no one can legitimately judge the moral quality of anyone else's actions.

To take an extreme example, a thoroughgoing relativist might say that there is no moral difference between Mother Theresa and Adolf Hitler – since both of them were just doing what they wanted to, we should not judge one as a saint and the other as a sinner. Relativists are fond of saying things like "one man's meat is another man's poison," "I'll do my thing and you do yours," or "I won't judge you because you have no right to judge me." Therein lies the path to moral ruin – as Edmund Burke is reported to have said, "All that is necessary for evil to triumph is for good men to do nothing." If good people see nothing wrong, or are reluctant to make judgments about wrongdoing, or find it too complicated, then evil will "triumph." [Burke is a favorite of "conservative" political philosophy.]

As will be noted shortly, the text does not want to pass judgment on Sam's choice, should he choose not to disclose the true nature of what he proposes to sell. I will.

<u>Teleology</u> is not *always* associated with egoism, enlightened or otherwise, but the text is correct in noting that some business ethicists will talk about teleology as 'consequentialist' – meaning that a moral philosophy that emphasizes "end results" is aiming toward some end point and is thus "teleological."

Strictly speaking, though, a teleology is any philosophical account which holds that final causes exist in nature, meaning that design and purpose analogous to that found in human actions are inherent also in the rest of nature as well. The word comes from the Greek *τέλος* - *telos*. The root, *τελε-* means "end, purpose." So, just as the ultimate or final purpose of an acorn is to "become" a mature oak tree, the final purpose of a human life is. . . .is what, exactly? Aristotle believed that the ultimate goal of human life is *euadamonia*, or the happiness that comes as a result of cultivating habits of virtuous character throughout your life.

So, we can see that not just any "purpose" will do – it has to be rooted in nature's ultimate purpose, which would be a matter of strenuous argument. [What is our purpose as "Americans"? Is it to maximize the accumulation of material goods? To "live free or die"? And what does "living free" mean, exactly? Being in a state of nature of every person for himself, or something else?] The text tells us that teleological philosophies assess the moral worth of a behavior by looking at its consequences; that is exactly what utilitarianism does, but without claiming any particular purpose "rooted in nature" other than what we desire as pleasurable or good. So we can discard teleology as a separate moral philosophy for ethics in contracting, and keep the one consequentialist theory that has the greatest influence on modern thought and action: utilitarianism.

Standard Ethical Perspectives

Utilitarianism

In the words of the late (and great) Tom Dunfee, who taught law and ethics for many years at the Wharton School of Business, 'lots of people think they are utilitarians – until they find out exactly what's involved."

Utilitarianism emphasizes not rules, but results. An action (or set of actions) is generally deemed "good" or "right" if it maximizes happiness or pleasure throughout society. Originally intended as a guide for legislators charged with seeking the greatest good for society, the utilitarian outlook may also be practiced individually and by corporations.

Jeremy Bentham believed that the most promising way to obtain agreement on the "best" policies for a society would be to look at the various policies a legislature could pass and compare the good and bad consequences of each. The right course of action from an ethical point of view would be to choose the policy that would produce the greatest amount of utility, or usefulness. In brief, the utilitarian principle holds that an action is "right" if and only if the sum of "utilities" produced by a certain act is greater than the sum of utilities from any other possible act.

This statement describes "act utilitarianism," Which "action" among various options will deliver the "greatest good" to society? Rule – utilitarianism is a slightly different version; it asks what rule or principle, if followed regularly, will create the greatest good? (But see *Digression*, below, at p. ___).

Notice that the emphasis is on finding the best possible results, and that the assumption is that we can measure the utilities involved. (This turns out to be more difficult that you might think.) Notice also the "sum total of utilities" clearly implies that in doing utilitarian analysis, we cannot be satisfied if an act or set of acts provides the greatest utility to us as individuals, or to a particular corporation – the test is, instead, whether it provides the greatest utility to society as a whole. Notice that the theory does not tell us what kinds of utilities may be better than others, or how much better a "good" today is compared to a "good" a year from today, or whether species other than human "count" or should be counted, or whether unborn human lives should be counted. Intergenerational equity – fairness to successive generations – seems to demand that we pay attention to what kind of world will leave to our children and grandchildren. But how should those lives be "counted" in a utilitarian calculation about fossil fuel reductions, and how costly such reductions might be to those living right now? One of the most important issues facing humankind is also the most complicated of all potential utilitarian calculations.

Yet whatever its limitations or difficulties, utilitarian thinking is alive and well in U.S. law and business. It is found in such diverse places as cost-benefit analysis in administrative/regulatory rules and calculations, environmental impact studies, the majority vote, product comparisons for consumer information, marketing studies, tax laws, and strategic planning. In management, people will often employ a form of utility reasoning by projecting costs and benefits for plan X vs. plan Y. But the issue in most of these cost/benefit analyses is usually (1) put exclusively in terms of money, and (2) directed to the benefit of the person or organization doing the analysis, and not the benefit of society as a whole.

An individual or company that consistently uses the test, "What's the greatest good for the company" is not following the utilitarian test of the greatest good overall. Below you will find some frequent mistakes that people make in applying what they think are utilitarian principles in justifying their chosen course of action.

1. Failing to creatively come up with lots of options that seem reasonable, and choosing the one that has the greatest benefit for the greatest number. (Often, a decision maker seizes on one or two alternatives without thinking carefully about other courses of action. If the alternative does more good than harm, the decision maker assumes it's ethically okay.)

2. Assuming that the greatest good for you or your company is in fact the greatest good for all; this means you are looking at situations subjectively, or with your own interests – or your company's interests – primarily in mind.

3. Underestimating the costs of a certain decision to you or your company. The now-classic Ford Pinto case demonstrates how Ford executives drastically underestimated the legal costs of not correcting a feature on their Pinto models that they knew would cause death or injury. GM was often taken to task by juries that came to understand that the company would not recall or repair known and dangerous defects because it seemed more profitable not to.

4. Underestimating the costs or harms of a certain decision to someone else or some other group of people.

5. Favoring short-term benefits, even though the long-term costs are greater.

6. Assuming that all values can be reduced to money. In comparing the risks to human health or safety against, say, the risks of job losses or profit losses, cost/benefit analyses will often try to compare "apples" to "oranges" and put arbitrary numerical values on human health and safety.

So, let's look at your text, the very last sentence on page 157. We see that farmers in China, and everyone else in the supply chain, were "thinking" that their "actions helped more people financially, rather than harm them from the unknown dangers of the additives." What is a "supply chain" other than a series of contracts that creates an end-use consumer who pays, directly or indirectly, everyone in the chain? In this example, we see several common mistakes that people make in thinking that their actions are justified by the "results."

[See Melamine Traces Found in Infant Formula, New York Times, Nov 25, 2008 at http://www.nytimes.com/2008/11/26/us/26formula.html]

A. Money has become the *de facto* standard of what is "good," even though money itself has no intrinsic value.

B. We see that humans in the supply chain typically prefer results in the present to results in the future, even though, on balance, the predictable harms to others are greater than the known, immediate benefits to the decision maker.

C. Systematically, we tend to underestimate the harms to others, especially if they are in the future, or at a great distance.

Behavioral psychologists tell us that we are often not objective when it comes to curbing our own self-interest where others could be hurt. And we know that we are often not very good at predicting the future. Yet utilitarianism depends on results: and it is necessary to make fairly accurate predictions about the future to be a utilitarian.

The text gives us this melamine situation as an example as utilitarian thinking, but it is not "good" utilitarian thinking. A true utilitarian would be able to see that his own self-interest was clouding his judgment, and that putting melamine in the milk product was harmful to others, and would not likely produce the greatest good to society. As Dunfee reminds us, "Lots of people think they are utilitarians – until they find out exactly what's involved."

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Digression on 'rule utilitarianism,' Kant, and bribery: the text also introduces us to a more general kind of utilitarianism that doesn't rely quite so much on specific predictions from specific acts: rule utilitarianism. (See textbook, p. 157). I would argue that rule utilitarianism is really an awkward version of Kantian deontology, the version that leans on reversibility as a feature of "universalizable" maxims. As such, it is a duty-based theory disguised as a consequentialist theory. See footnote 4, below.

But briefly, let's say this: if bribery in general leads to bad consequences, we as rule-utilitarians will adopt a *rule* against bribery. But in doing so, we justify the rule against bribery by observing that if everyone bribed all the time, the results would be very bad, so we won't ever bribe. So far, so good. Rule utilitarians would then be saying that there may be specific situations where bribery may seem to be justified on act-utilitarian grounds, but since, in general, it has bad consequences for society, it is not ethical.

But the same kind of generality or abstract thinking can be applied in a Kantian or deontological way, as well. Using "reversibility," which some Kantians will do, we see that the "Golden Rule" is probably offended as well: we like bribery when officials accept our bribe, but we don't like it when officials accept someone else's bribe. On an even more general level, bribery can't be universalized: bribery requires secrecy, but we always want to know just what's going on (no secrets from us!) but don't mind keeping a few secrets of our own. This is inconsistent, or, in other words hypocritical.

Kant would probably address bribery as a form of secrecy or dishonesty; the bribe is not public, nor can it be – it is, by definition, a secret pay-off to get a contract. Kant would say that secrecy as a general, universalizable maxim is absurd, as well – if everything were <u>always</u> secret, and <u>never</u> shared as knowledge with others, there would be no truth or reality apart from what is "known" to one person. Such a state of affairs is conceptually and linguistically absurd and impossible. Get it?[3]

Below, I will explain why bribery is a contradiction to basic, free market principles, and (not surprisingly) is often associated with corrupt governments. Friedman would also condemn the deceit involved (the public is defrauded when government contracts are given not for the best bid, but for the bidder with

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[3] Language requires that we share our thoughts with others. No sharing, but only secrets = no language. "Knowledge" would be very limited, indeed. Kant's logical point (the conceptual piece here) is that "secrets" depend upon there being knowledge that is shared - with a very small set of people. If there were only secrets, there could be no shared knowledge. Open-ness is universalizable; secrecy "writ large" makes no sense at all.

money under the table), and we could add that "the rules of the game" are violated as well – at least, the rules of the game of honest, competitive bidding. If the "game" is all about bribery, the game is not being played on a level playing field, and is not (in utilitarian terms) an efficient allocation of resources.

Rule utilitarianism may seem like an improvement on act utilitarianism, but it takes some of its persuasiveness from related notions from deontology, as we see in the above few paragraphs. Also,

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Precisely because act-utilitarianism leads is difficult to apply, and is easily abused by those with self-interest foremost in mind (such as in cases like melamine in milk, or with bribery, or in contract negotiations where important truths are deliberately not told), ethicists often point to "duty" as a more reliable way of seeing moral problems clearly and guiding our actions.

<u>Deontology</u>

The text emphasizes "rights," and we should quickly add that "rights" imply that others have duties to observe and ensure those rights. Sam Colt, our bolt salesperson, knows that the rights of others are implicated in this situation: if his company sells bolts for the bridge that is more likely to fall apart during a predicted earthquake, then the rights of others will be adversely affected. Thus, he has a <u>duty</u> to disclose the exact nature of what he is selling.

The text correctly notes that Sam, as a deontologist, would inform the bridge contractor and probably lose the sale. [The text also says that, as a utilitarian, he could easily not disclose the nature of his product, and would likely "rationalize" this decision. But notice – and this is critically important – there is a competitor to Midwest Hardware that makes bolts that are better. The text does not tell us that Midwest bolts would be less expensive, and thus save money for the bridge contractor. But, even assuming that the contractor could save money by going with Midwest Hardware, how can we know that this creates the greatest good for society? The tendency, of course, is to "rationalize" (meaning, to attribute your actions to rational motives without analyzing the true and especially unconscious motives, thus creating a more attractive explanation for what you do).

You rationalize when your mind is convinced it must be the greatest good, but what's really driving this conclusion is that the choice to not disclose delivers short-term results to you (Sam) and your firm, Midwest. But to ***know*** that you are creating the greatest good, you must also ***know***, to some reliable extent, the following:

- the likelihood of an earthquake
- the likely impact of an earthquake on the bridge using Midwest Hardware bolts
- the likely impact of an earthquake on the bridge using your competitor's bolts
- the average number of cars on the bridge at any one time over 24 hours
- whether earthquakes along the New Madrid line are apt to happen during the day, or in the early morning hours when very few vehicles are on the bridge
- the value of the human lives and property on that bridge, on average
- the cost to society of replacing that bridge in the future
- the benefit (utility) to society of a bridge that actually withstands the earthquake, and the costs (disutility) to society of not having that bridge in place after the earthquake
- the probable results of your disclosing the defect rate to the contractor
- the probable actions of the contractor in response to disclosure
- all other options that you [Sam] or Midwest Hardware could take in this situation.
- the likelihood that Midwest Hardware's management would take the profits from the bridge contract and create more value; that is, how probable is it that doing this deal will bring about good even in the limited realm of Midwest Hardware, its employees, customers, and related stakeholders? If the company is poorly managed, and cannot produce "better bolts," then how important/useful to society is the survival of Midwest Hardware as a business entity?

Will Sam (or Midwest) do this kind of calculation? Almost certainly it will not. Could it even be done successfully? Only with rough figures, but it starts to look like the risks/costs to society are potentially quite large. That is, the downside of non-disclosure is potentially very great, while the "upside" appears to be substantially less. Yet the text rather carefully notes: "We don't judge the quality of Sam's decision." (Page 153)

But, why don't they? Why not judge the quality of Sam's decision, or of Midwest Hardware's decision? We regularly assess our decision-making processes, individually and in business settings. Decisions can be ill-advised, incautious, selfish, and scatters, about our decisions and those of others? In fact we do, and to do so is what makes us better decision makers. Suspending judgment is a form of **moral relativism**, as in "Well, he's probably not making an ethical decision, but it's not for me to judge." If we cannot make better decisions, and more ethical ones, we might as well write off "business ethics" right now.

But I am not willing to suspend judgment. If Sam and Midwest just say, "This is a business decision. It has nothing to do with ethics. We're out to make money any way we can," at least that's honest. It's not ethical in other respects, but it's not pretending to go beyond selfish concerns. They have already characterized their actions – judged them, in effect – as lacking any discernible ethic, other than egosim (which is **not** an ethical perspective).

But if Sam or any one else is going to put on the mantle of a true utilitarian to justify a decision, he (and his company) must take careful consideration of all potential downsides as well as upsides, <u>and to all stakeholders, present and future</u>, not just the financial results of the quarter or this year's bonus or me or my company. Otherwise it is not the greatest good for society that is being calculated, but rather the greatest good for Sam and for Midwest. Predictions and probabilities are notably difficult, and all of us are prone to conflicts of interest and other human failings.

In short, Tom Dunfee was right: utilitarianism sounds good, as though we could actually make these calculations without too much difficulty. But we can't predict well, and we often poison the well of well-considered utilitarian calculations with our own self-interest. When we learn what utilitarianism *really* involves, it really is a lot less appetizing.

The deontologists would say, in light of all this, that "duty" is a more reliable method of securing others' rights than happily biased projections into the future of what we want to happen. Rosy scenario #1 is: "This bridge will not collapse. No way. And besides, I can get my bonus!"

What is the fundamental duty here? To tell the truth. Kant would say that truth-telling is universalizable: we want others to tell the truth[4] and truth-telling can be consistently and everywhere practiced in the real world.

Here's a "thought experiment": What if everyone told the truth all of the time? It's possible to imagine such a world, even if constant truth-telling might be less than appealing. [Do you really want to tell your friend or spouse that their fresh haircut is atrocious?] But, what if everyone lied all the time? The result is not appealing, but, more importantly, it is literally impossible: people cannot tell lies without there being general expectations of truth-telling. That is, a lie only "works" if someone believes that someone is telling the truth, and that could not happen in a world where everyone lied constantly.

What would Friedman say? Is there deceit here? Certainly, there is. The truth, the whole truth, and nothing but the truth requires Sam to tell the contractor exactly what his bolts cost, what they can do, and what they cannot do. We all **know** why he'd rather not, but it can't be dressed up as "utilitarian thinking" to be given some sort of "justification." (the root word here is "just," meaning "fair" or "right.") In short, I disagree with the text. The utilitarian line of thinking Sam engages in on page ___ is false utilitarianism. It fails to ask enough hard questions, fails to take probabilities and costs into realistic account, and falls prey to the usual shortcomings of easy utilitarian "thinking": I "have to" get this contract for the company, nothing bad will happen, if it does it won't be too costly to me or to others, and, that bonus is going to be "sweet"!

Here's an important quotation from the textbook: "ethical issues can be evaluated from many different perspectives. Each type of philosophy discussed here would have a distinct basis for deciding whether particular action is right or wrong. Adherents of different personal moral philosophies may disagree in their evaluations of the given action, yet all are behaving ethically according to their own standards. All agree that there is no one right way to make ethical decisions and no best moral philosophy except their own." (pp. 159 - 160)

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[4] Some writers have included the notion of "reversibility" as part of Kantian thinking. If you would not want others to lie to you, you would have a duty not to lie to others. Readjusting this slightly, you might allow others to tell "white lies" (lies that you would be happier to be told than hearing the truth), but, with that exception, prefer truth telling with occasional white lies as a general maxim or rule. Students will recognize "reversibility" as a form of the Golden Rule: do unto others as you would have them do unto you.

It is more helpful to say that each of these perspectives can give us insight, and that we should filter our decisions through a number of different ethical lenses. Thus far, in Sam's case, we have Milton Friedman's insights about corporate social responsibility, we have utilitarianism, and we have deontology. Friedman and Kant weigh in decisively against Sam for failing to disclose the truth about the defect rate. We also see now that the utilitarian "analysis" or justification as seen in the text falls far short of what a true utilitarian analysis would involve. Zero for three thus far: what would "virtue ethics" have to say?

Virtue Ethics

Your text has a good section on virtue ethics. Allow me to add just a bit more, and to provide a practical tool that will help evaluate Sam Colt's actions, as well as your own.

Virtue theory has received increasing attention over the past twenty years, particularly in contrast to utilitarian and deontological approaches to ethics. Virtue theory emphasizes the value of virtuous qualities rather than formal rules or useful results. Aristotle is often recognized as the first philosopher to advocate the ethical value of certain qualities or virtues in a person's character. As LaRue Hosmer has noted, Aristotle saw the goal of human existence as the active, rational search for excellence, and excellence requires the personal virtues of honesty, truthfulness, courage, temperance, generosity, and high-mindedness. This pursuit is also termed "knowledge of the good" in Greek philosophy.[5]

Aristotle believed that all activity was aimed at some goal or perceived good, and that there must be some ranking that we do among those goals or goods. Happiness may be our ultimate goal, but what does that mean, exactly? Aristotle rejected wealth, pleasure, and fame and embraced "reason" as the distinguishing feature of humans, as differing from other species. Thus, since man is a reasoning animal, happiness must be associated with reason. Thus, happiness is living according to the active (rather than passive) use of reason. The use of reason leads to excellence, and so happiness can be defined as the active, rational pursuit of personal excellence, or virtue.

His list of 14 virtues includes (1) courage, particularly in battle; (2) temperance, or moderation in eating and drinking; (3) liberality, or spending money well; (4)

[5] LaRue Tone Hosmer, Moral Leadership in Business (1994), at 72.

magnificence, or living well; (5) pride, or taking pleasure in accomplishments and stature; (6) high-mindedness, or concern with the noble rather than the petty; (7) unnamed virtue, which is halfway between ambition and total lack of effort; (8) gentleness, or concern for others; (9) truthfulness; (10) wit, or pleasure in group discussions; (11) friendliness, or pleasure in personal conduct;(12) modesty, or pleasure in personal conduct; (13) righteous indignation, or getting angry at the right things and in the right amounts; and, (14) justice.

From a modern perspective, some of these virtues seem old- fashioned or even odd. Magnificence, for example, is not something we commonly speak of. Several issues emerge: (1) how do you know what a virtue is these days? (2) how useful is a list of agreed-upon virtues anyway? and (3) what do virtues have to do with companies, particularly large ones where various groups and individuals may have little or no contact with other parts of the organization?

As to the third question, whether corporations can "have" virtues or values is a matter of lively debate. A corporation is obviously not the same as an individual human. But there seems to be growing agreement that organizations do differ in their practices, and that these practices are value-driven. If all a company cares about is the bottom line, other values will diminish or disappear. Quite a few books have been written in the past twenty years that emphasize the need for businesses to define their values in order to be competitive in today's global economy.[6] As to the first two questions, a look at Michael Josephson's Core Values may prove helpful.

Josephson's Core Values Analysis and Decision Process

Michael Josephson, a noted ethicist based in California, believes that a current set of values has already been identified, and that the values can be meaningfully applied to a variety of personal and corporate decisions.

To simplify, let's say that there are ethical and non-ethical qualities among people in the U.S. When you ask people what kinds of qualities they admire in others (or in themselves), they may say "wealth," "power," "fitness," "sense of humor," "good looks," "intelligence," or "musical ability," or some other quality. They may also value "honesty," "caring," "fairness," "courage," "perseverance,"

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[6] *See, e.g.* Good Business: Exercising Effective & Ethical Leadership (Routledge: Taylor and Francis), 2010.

"diligence," "trustworthiness," or "integrity." Each of the qualities on this second list has something in common—they are distinctively ethical characteristics. That is, they are commonly seen as moral or ethical qualities, unlike the qualities on the first list. You can be, like Alcibiades, brilliant but unprincipled; or, like some political leaders of today, powerful but dishonest, or wealthy yet uncaring. You can, in short, have a number of admirable qualities (brilliance, power, wealth) that are not, in themselves, virtuous. Just because Harold is rich, good-looking, or has a good sense of humor does not mean that he is ethical. But if Harold is honest and caring (whether he is rich or poor, humorous or humorless) people are likely to see him as ethical.

Among the virtues (and there are many[7]), some are especially important. Studies from the Josephson Institute of Ethics in Marina del Rey, California (which has organized the Character Counts Coalition) find that there are six core ethical values in our society, values that almost everyone agrees are important to them. When asked what values people think are essential, and what ethical values they wish to be known by, and what ethical values they wish others would live by, six values consistently turn up. They are (1) trustworthiness, (2) respect, (3) responsibility, (4) fairness, (5) caring, and (6) citizenship.

Note that these values are distinctly ethical. While many of us may value wealth, good looks, and intelligence, having great wealth, good looks, and super-intelligence does not automatically make us virtuous in our character and habits. But being more trustworthy (by being honest and by keeping promises) does make us more virtuous, as does cultivating and maintaining habits of action that are true to the other five core values.

Notice also that these six core values are both different from and similar to other values that are deeply held. I call these the 'non-core ethical values.' They involve strongly held beliefs about what is right and proper, but they are not as widely held. Many values taught in the family or in places of worship are not generally agreed practiced or admired by all. For example, some families and individuals believe strongly in the virtues of saving money, or abstaining from alcohol, or refraining from sexual relations prior to marriage. Others clearly do

[7] See William Bennett's *The Book of Virtues: A Treasury of Great Moral Stories*, which lists many virtues such as self-discipline, compassion, responsibility, friendship, work, courage, perseverance, honesty, loyalty, and faith. In 2003, Bennett disclosed a long-time habit of compulsive gambling. Some people believed that Bennett would be diminished as a moral authority as a result. But is gambling unethical? What criteria would you use to determine the answer?

not, or at least they don't act on their beliefs. Moreover, it is possible to have and practice core ethical values even if you take on heavy debt, knock down several drinks a night, be "420 friendly," or make a habit of premarital or extra-marital sex. Some would hotly dispute this, saying that you can't possibly lead a virtuous life and drink heavily, engage in premarital sex, or get deep into debt. But the point here is that people <u>do disagree</u> about whether the traits of thrift, temperance, abstaining from marijuana use, or sexual abstinence are necessary traits for an ethical person to cultivate. Since these traits do not have the unanimity of approval that the six core values do, they are ethical values, but not core ethical values.

The importance of having the core values as consistent qualities of character is often overlooked in our desire to "succeed." You may think you are the most ethical person you know, but, sorry to say – most of us are not believed by those who know us best to be "highly ethical." Often, people remember the last bad thing we did, far more than any or all previous good acts.

For example, as public officials, Elliott Spitzer and Bill Clinton are more readily remembered by people for their last, worst acts than for any good they accomplished as public servants. A company's good reputation also has an incalculable value that, when lost, takes a great deal of time and work to recover.

Ask Tiger Wood about the money value of a good reputation. Ask Shell, Nike, and many other companies that have discovered that there is a market for morality, however difficult to measure, and that not paying attention to business ethics often comes at a serious price. In the past fifteen years, the career of "ethics and compliance officer" has emerged, partly as a result of criminal proceedings against companies, but also because major companies have found that reputations cannot be recovered retroactively, but must be pursued proactively. For individuals, Aristotle emphasized the practice of virtue to the point where virtue becomes a habit. Companies are gradually embracing the same wisdom.

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Let's see if we can apply this to Sam Colt and Midwest Hardware. Pretty much right on the money, the text says that if Sam Colt were "into" virtue ethics, he would consider the elements of virtue and then tell the prospective customer about the defect rate and about his concerns regarding the building of the bridge.

He would not resort for free to explain the product or its risks and, indeed, might suggest alternative products or companies that would lower the probability of the bridge collapsing.

I would break it down this way: in terms of specific core values, Sam would thus be practicing **trustworthiness** (he tells the truth, and he is not promising the products will do what it cannot do), **respect** (he respects the autonomy of the contractor in giving the contractor the facts, and letting the contractor make a free, informed choice), **responsibility** (because he's being accountable and thinking about the consequences to others; he is setting the example and exercising self-restraint: he knows the difference between what he has a right to do and what is right to do), **fairness** (he is not letting personal feelings about his bonus improperly interfere with his decisions), **caring** (he is treating the contractor as he would want to be treated), and **citizenship** (he is helping the community and conserving resources).

Here are the six core values, with a breakdown of each value's constituent parts.

TRUSTWORTHINESS: Be honest - tell the truth, the whole truth, and nothing but the truth; be sincere, forthright; don't deceive, mislead, or be tricky with the truth; don't cheat or steal, and don't betray a trust. Demonstrate integrity - stand up for what you believe, walk the walk as well as talking the talk; be what you seem to be; show commitment and courage. Be loyal - stand by your family, friends, co-workers, community and nation; be discreet with information that comes into your hands; don't spread rumors or engage in harmful gossip; don't violate your principles just to win friendship or approval; don't ask a friend to do something that is wrong. Keep promises - keep your word, honor your commitments, and pay your debts; return what you borrow.

RESPECT: judge people on their merits, not their appearance; be courteous, polite, appreciative, and accepting of differences; respect others' right to make decisions about their own lives; don't abuse, demean, mistreat anyone; don't use, manipulate, exploit, or take advantage of others.

RESPONSIBILITY: Be accountable – think about the consequences on yourself and others likely to be affected before you act; be reliable; perform your duties; take responsibility for the consequences of your choices; set a good example and don't make excuses or take credit for other people's work. Pursue excellence: Do your best, don't quit easily, persevere, be diligent, make all you do worthy of pride. Exercise self-restraint – be disciplined, know the difference between what you have a right to do and what is right to do.

FAIRNESS: Treat all people fairly, be open-minded; listen; consider opposing viewpoints; be consistent; use only appropriate considerations; don't let personal feelings improperly interfere with decisions; don't take unfair advantage of mistakes; don't take more than your fair share.

CARING: show you care about others through kindness, caring, sharing, compassion, and empathy; treat others the way you want to be treated; don't be selfish, mean, cruel, or insensitive to others' feelings.

CITIZENSHIP: play by the rules, obey laws; do your share, respect authority, stay informed, vote, protect your neighbors, pay your taxes; be charitable, help your community; protect the environment, conserve resources.

Remarkably, we see these core values – and other ethical perspectives – reflected in the basic rules of contracting. That is, "society" has enshrined many of these values in the contracting system that we see in our cases.

Offer and Acceptance: the parties are held to a standard of **trustworthiness** – a deal is a deal, and the parties' promises will be binding unless there is a worthy excuse. (Worthy here often means morally compelling.)

Consideration: the parties' autonomy is respected. You are free to make an incautious or even a "bad" deal, and the courts will not revisit the basis of the bargain as long as there is capacity, offer and acceptance, and legality. This underlines the notion that each party must take **responsibility** for their actions.

Capacity: as Kant says, we should not use or exploit others for our own purposes. The law does not allow us to take advantage of the drunk, the deranged, the infirm, or the under-aged. **Respect** is not legally guaranteed; that's mostly up to us as ethical people, but respect is supported socially/legally through these rules on 'capacity.' Rules on duress and unconscionability support the values of **fairness** and respect, as well.

Legality: **Citizenship** is underscored here, as society modifies "freedom of contract" to put certain agreements beyond public enforcement. If I hire a hit-man to kill my rival, pay him $10,000, and he fails to get the job done (suppose my rival now walks with a slight limp, but is otherwise unimpaired), I can't go to court to recover all or part of the monies paid. Michael Walzer has noted, in Spheres of Justice, that there are very good reasons and values behind the fact that we are not entirely free to contract for anything we want. Perhaps you want to own a slave, buy votes, buy an "A" in BUS 212, buy cocaine, "buy" a government contract, or own your own F-15, complete with nuclear weaponry (as your "right" to bear arms) – you might succeed on "the black market," but not in legitimate business.

Justice

The section of the text on Justice is short and to the point. Applying it to Sam's case is a little harder to do than with the deontological or virtue perspectives, but it's a bit easier than making an exhaustive utilitarian analysis. Distributive justice is described well enough, but is full of complications. In brief, distributive justice would have Sam decide based on a consideration of many stakeholders, not just stockholders, with some sense of proportion, equity, or fairness toward all stakeholders taken into account. Because several different outcomes could be roughly consistent with proportional fairness toward all stakeholders, the distributive justice perspective would eliminate only the most imbalanced outcomes.

Other Important Ethical Perspectives

Social Contract – Social Justice

Some social contractarians, such as John Rawls, also concerned with justice. (A Theory of Justice is widely regarded as his signature work.) Rawls' famous "veil of ignorance" challenges us to figure out who would get what in a just society (that is, how the "goods" would be justly or fairly apportioned) if we set up in advance a system of distributed goods, having no idea what part of society we would wind up in. Would we be poor, or rich? Black, white, or hispanic, Indian? Male or female? Young or old? We would not know. We would make these arrangements behind a "veil of ignorance" that would keep us from being blinded by self-interest.

In the usual "pie cutting" test, suppose you have one of the world's greatest berry pies. There are six of you, all hungry, all loving the Achatz four- berry pie (well known in Michigan, by the way), and YOU get to divide the pie. The other five are looking on, and no one knows who gets the first choice of pie pieces. You would – it is almost always supposed – cut the pie into six equal parts so that when your turn came (you might not, after all, get first pick) your piece would be about as generous as anyone else's. Simplified, that's the basic idea behind the veil of ignorance.

What IS the fair way to distribute goods among a group of people? Rawls proposed the veil of ignorance, and provided several other tests for a just society. Marxist thought emphasized that members of society should be given to according to their needs. But this re-distribution would require a governing power to decide who gets what, and when. Capitalist thought takes a different approach, and rejects any "giving" that is not voluntary. Economists such as Milton Friedman would also reject the notion that a corporation has a duty to give to unmet needs in society, believing that the government should play that role. Even the most dedicated free market capitalist will admit the need for some government and some forms of welfare – social security, Medicare, assistance to flood-stricken areas, AIDs patients – along with some public goods (such as defense, education, highways, parks, and support of key industries affecting national security).

People who do not see the need for public goods (including laws, court systems and the above-mentioned government goods and services) often question why there needs to be a government at all. One response might be, "Without government, there would be no corporations." [Corporations are "persons" legally, and are a creation of government that allows for limited liability to investors.][8] Thomas Hobbes believed that people in a "state of nature" would rationally choose to have some form of government. He called this the "social

[8] Some commentators also see a kind of social contract between corporations and society; in exchange for perpetual duration and limited liability, the corporation has some corresponding duties toward society. Also, if a corporation is legally a "person," as the Supreme Court re-affirmed in 2010, then some would argue that if this corporate person commits three felonies it should be locked up for life – its corporate charter revoked!

contract," where people gave up certain rights to government in exchange for security and common benefits. In your own lives, and in this course, you will see an ongoing balancing act between human desires for freedom and human desires for order; it is an ancient tension. In the U.S., there has been a noticeable shift since 9-11 for greater security (order) and less freedom.

Modern social contract theorists, such as Tom Donaldson and Tom Dunfee at the Wharton School of Business, observe that various communities make rules for the common good, not just nations. Your college or school is a community, just as there are communities within the school (fraternities, sororities, the folks behind the counter at the circulation desk, the people who work together at the university radio station, the sports teams, the faculty, the students generally, the gay and lesbian alliance) that have rules, norms, or standards that people can buy into or not. If not, they can exit from that community, just as we are free (though not without cost) to reject U.S. citizenship and take up residence in another country.

Donaldson and Dunfee's Integrative Social Contracts Theory (ISCT) stresses the importance of studying the rules of smaller communities along with the larger social contracts made in states (like Florida or California) or nation-states (like the U.S. or Germany). Our Constitution can be seen as a fundamental social contract.

ISCT takes careful account of the relativism perspective noted in your textbooks. It would disagree with several key statements made. While it is evident that communities and nations have differing values and practices, and that these practices deserve serious moral consideration, great care must be taken not to assume that something widely practiced is admired and respected as an ethical "norm." Norms that are "authentic" would have been discussed, lived with, debated, and settled with the voice and consent of the people in that community. If bribery is a "way of life" in Nigeria, it still may not rise to the level of an ethical norm; the people there may hold their noses (as in India) and put up with it, but <u>not</u> engaging in the practice is certainly not unethical, and engaging in the practice may be seen as a necessary evil, rather than a moral good.

ISCT has a complicated but sensible approach: simply put, in a society where the values, norms, and customs are very different from your own, be careful to know if the norm is "authentic," and follow it unless there are widely held, nearuniversal beliefs and practices (hypernorms) that contradict it. Nepotism[9] in India, for example, seems to be an authentic local norm, but one which is not proscribed (prohibited) by any wider, fundamental moral sensibility. Collaborating with the military regime in control of Myannmar may seem like the culturally – or at least politically – appropriate or expedient thing to do (using slave labor, as Unocal is alleged to have done in constructing a pipeline), but doing so is contrary to more widely held norms of appropriate behavior (e.g., religious injunctions against slavery, philosophical views against slavery, legal prohibitions of slavery, including global conventions/treaties prohibiting slavery).

It is important to realize that a social contract can be changed by the participants in the community. In public, the TSA is getting us used to orange alerts and ever-increasing intrusions into our effects and bodies. In private, Facebook has forced a kind of public intimacy that few people would have countenanced just twenty years ago. [The times, they are a changin'.] Social contract theory is thus dynamic—it allows for structural and/or organic changes over time. In India, employers may gradually move away from nepotism in hiring, and Saudis may eventually allow women in the workplace. Ideally, the social contract struck by citizens and the government allows for certain fundamental rights such as those we enjoy in the United States, but it need not. People can give up freedom-oriented rights (such as the right of free speech, or the right to be free of unreasonable searches and seizures) to secure order (freedom from fear, freedom from terrorism). For example, many citizens in the Russia now miss the days when the Kremlin was all-powerful. For some, order (as a value) is prized above freedom (as a value).

Social contracts and Sam Colt: let's suppose that Americans believe in capitalism, the entreprenuerial spirit, or some such thing; it's part of our belief system, and thus, our social contract. What does that mean? We have an understanding, more or less, of what that is. We prize those who take risks and reap the rewards; we prize personal initiative and hard work. Does Sam's non-disclosure violate a general sense of what we believe to be true, good and right? (Yes. See ____ below)

[9] Nepotism is the practice of hiring other family members or in-laws, rather than going strictly by "merit" in selecting employees.

Communitarianism

Another important movement in ethics and society is the communitarian outlook. Communitarians emphasize that rights carry with them corresponding duties; that is, there cannot be a right without a duty. Interested students may wish to check out the work of Amitai Etzioni. The Communitarian Network is a group of individuals who have come together to bolster the moral, social, and political environment. It claims to be nonsectarian, nonpartisan, and international in scope.[10]

The relationship between rights and duties – in both law and ethics – calls for some explanations.

(1) If you have a right of free expression the government has a duty to respect that right. But reasonable limits can be put on that right. For example, you can legally say whatever you want about the U.S. President, but you can't get away with threatening the President's life. Even if your criticisms are strong and insistent, you have the right (and our government has the duty to protect your right) to speak freely. In Singapore during the 1990's, even indirect criticisms—mere hints—of the political leadership were enough to land you in jail, or at least silenced by a libel suit. In Russia, a very successful capitalist, Mikhail Khodorkovsky, is still in jail, most likely for speaking out against Vladimir Putin.[11]

(2) Rights and duties are not only between people and their governments, they are also between people: your right to be free from physical assault is protected by the law in most states, and when someone walks up to you and punches you in the nose, your rights—as set forth in the positive law of your state—have been violated. Thus, other people have a duty to respect your rights and to not punch you in the nose.

(3) Your "right" in legal terms is only as good as the community's willingness to provide relief within the legal system. A "right to privacy," for example, changes with changed circumstances; post 9/11, pat-downs and body scanners at

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[10] The communitarians have a web site – http://www.gwu.edu/~ccps/

[11] http://www.nytimes.com/2010/11/06/business/06nocera.html

airports are considered acceptable (though not without some "don't touch my junk" controversy).

A distinction between basic rights and non-basic rights may also be important. Basic rights may include such fundamental elements as food, water, shelter, and physical safety. Another set of distinctions is between positive rights (the right to bear arms, the right to vote, the right of privacy) and negative rights (the right to be free from unreasonable searches and seizures, the right to be free of cruel or unusual punishments), and between economic or social rights (adequate food, work, and environment) and political or civic rights (the right to vote, the right to equal protection of the laws, the right to due process).

Friedman, of course, has his own conception of which rights are most important. We return now to the Friedman's rejection of corporate social responsibility, remind ourselves of the stakeholder model, and inject a new set of concepts. We will start with conscious capitalism, and the debate between Milton Friedman and John Mackey (CEO of Whole Foods).

Conscious Capitalism

One effort to integrate the two viewpoints of stakeholder theory and shareholder primacy is the "conscious capitalism" movement. Companies that practice conscious capitalism embrace the idea that profit and prosperity can and must go hand in hand with social justice and environmental stewardship. They operate with a holistic or systems view. This means that they understand that all stakeholders are connected and interdependent. They reject false trade-offs between stakeholder interests and strive for creative ways to achieve win-win-win outcomes for all. [12]

For contracts, this means the replacement of win-lose scenarios with win-win scenarios. Often in your contracts cases you will see two parties pitted against one another, and it's winner take all. Conscious capitalism would remind market participants that relationships matter, that stakeholders are integral to the success of a business monetarily, and that while resources may be scarce, there is

[12] A leading proponent of Conscious Capitalism is Whole Foods' John Mackey. His debate with Milton Friedman can be found in Reason Magazine. See http://reason.com/archives/2005/10/01/rethinking-the-social-responsi

unexpected abundance in making employees and customers the heart of a sustainable business. Short-term thinking that squeezes more and more productivity out of fewer and fewer workers would not, in the long run, be monetarily or socially responsible. The end result would maximize profits, but not by focusing exclusively on short-term return to shareholders.

But the "conscious business" has a purpose that goes beyond maximizing profits. It ***is*** designed to maximize profits, but is focused more on its higher purpose, and does not fixate solely on "the bottom line." To do so, it focuses on delivering value to all its stakeholders, harmonizing as best it can the interests of consumers, partners, investors, the community, and the environment. This requires that company management take a "servant leadership" role, serving as stewards to the company's deeper purpose and to the company's stakeholders.

Conscious business leaders serve as stewards to the company's deeper purpose and its stakeholders, focusing on fulfilling the company's purpose, delivering value to its stakeholders, and facilitating a harmony of interests, rather than on personal gain and self-aggrandizement. Why is this re-focusing needed? Within the standard profit-maximizing model, corporations have long had to deal with the "agency problem." Actions by top level managers – acting on behalf of the company – should align with the shareholders, but in a culture all about winning and money, managers sometimes act in ways that are self-aggrandizing and do not serve the interests of shareholders. Laws can try to sanction executives that over-reach, but often the remedies are often too little and too late, and are only effective for the most egregious over-reaching. Having a culture of servant leadership is a much better way to see that a company's top management works to ensure a harmony of interests.

"LET'S GET REAL": HE'S **GOT** TO GO FOR THE MONEY, or HE'S **GOT** TO GO ALONG TO GET ALONG

All of this rumination about ethical perspectives can leave us quite skeptical about ethics, given "the world as it really is." Experiments (and common sense) have shown that people are quite willing to harm others in a social context where obedience to authority or "groupthink" is present. [13] Contracts are part of this process; if Sam feels "bound" by his contacts with family needs, loyalty to his organization, and others urging him on, how "independent" or "free" can he be? The Kohlberg ideas noted on pages _____ of the text are still widely accepted; other research indicates that only a small percentage of people (perhaps 15%) reach the post-conventional level, a level of moral independence that would enable them to be a Jeffrey Wiegand, a whistleblower, or someone who would say 'No' to authority or group dynamics.

So, we can expect Sam to be typical. Moreover, we believe that "Nice guys finish last," and that telling the truth about the bolts only consigns us to a moneyless future. In this nation, that can seem like a sentence of death. See Matt Taibi's recent article about mortgage foreclosures in Florida, noted at the end of this document. His somewhat appalling conclusion, which seems eerily convincing, is that in the U.S. today, being poor has somehow become more shameful than being a liar or criminal. This has enormous implications for the question of "who we are" as a national "community" – that is, what is our social contract: what do we value, and how do we prioritize those values in our conduct of social/legal relations?

In short, you can check all the "boxes" of the various ethical perspectives, and understand that Sam "should" tell the truth for this to be a "good contract." But *some would say that this just isn't real; in life as it is lived in this country, we are wasting our time to talk about ethics. And why, by the way, are we talking about "ethics" in a business school? Sam will of course do what he "has" to do, to make money, or to go along with his "posse" (family, co-workers, etc.). And Midwest Hardware will try to fatten its bottom line, for shareholders and for CEO bonuses this holiday, because that's what businesses do. Period. End of discussion.*

Okay, I "get it," and I've heard this hundreds of times. But I thought we believed in capitalism. Our "poster child" for capitalism, Milton Friedman, warns against deceit in business transactions. Maybe we can rationalize that not disclosing the truth is not deceit. But it's only rationalization, or making excuses. How can we

[13] In this regard, see Stanley Milgram: Obedience, A Filmed Experiment. On You Tube, you can find a British re-enactment of the experiment. See http://www.youtube.com/watch?v=BcvSNg0HZwk&feature=related.
See also the Stanford Prison Experiment, http://www.youtube.com/watch?v=rmwSC5fS40w&feature=related
Zimbardo's prison experiment, like Milgram's experiment, showed that many people would inflict serious pain on others if that was "what was expected" by those in "authority."

call ourselves "free market capitalists" where we take the money and pass the risk on to someone else? There is something quite worthy, even virtuous, in our belief that those who take the risks should reap the rewards, and those who "play it safe" should be content with incremental gains or incremental losses. The problem with Sam and the bridge is that he and his company are taking the short-term rewards and passing any risks to the public at large, and to the contractor, and to the folks that own Midwest Hardware in years to come who would suffer the loss of reputation when the rosy scenario crumbles with the next quake. The rewards that Sam and his company propose to take, in other words, are not directly linked to risks that they personally are taking.

Does this sound all too familiar? It should. Financiers on Wall Street aided and abetted the mortgage industry, an industry that happily collected origination fees and other fees and passed along subprime mortgages in CDOs and SIVs to investors that bore the actual risk. All reward! No risk! What angers many people in the United States today is that the old social contract seems to have been torn up. Well-connected people who are clever enough to create financial products get high rewards with little risk of failure, given government bail-outs. President Bush bailed out the banks that led many people to financial ruin, then President Obama put the same people in charge of Treasury and the Federal Reserve.

In the very same way, though on a smaller scale than the financial fraud that led to the meltdown of 2008, Sam and Midwest are very happy to take the money now and let others suffer the consequences later. When the bridge collapses, who will pick up the tab for all the human and social costs? Who will pay to replace the bridge? Who will send in the Army Corps of Engineers? Who will create the makeshift ferry service over the river to take the place of the bridge that has fallen? It won't be Midwest Hardware, it won't be the contractor, and it won't be Sam: it will be the federal taxpayer.

Economists like Milton Friedman have a phrase for this sort of thing: negative externalities. You and I enter into a contract for the sale and purchase of X (whatever). The sale and purchase has a price we agree to, but, sooner or later, someone else entirely pays a price that is not included in our transaction. For example, I buy a truckload of cement. The cement comes from a factory that produces it, prices it, and takes a profit at a sales price of $16 per 50 pound bag. The cement factory creates dust, soot, and noise, and adversely affects the health of neighboring property owners. The social costs that those people incur (medical bills, for example) are not included in the price of the product. The full costs of the enterprise, in short, are not included in the price of the product. Those costs are negative externalities. As an economist, Friedman would say that these are market failures. In a like manner, if Bank of America doesn't have to pay the full negative externalities generated by Countrywide Mortgage, or if Midwest Hardware does not have to pay the negative externalities of the bridge's collapse, there is market failure.

So, not only is there deceit in Sam's non-disclosure, but potential market failure as well – a direct affront to a well-functioning, competitive market system, where risk and reward have not become so disconnected.

One buzzword in business is "accountability." As buzzwords go, it's a very good one: in an effective organization, people are accountable for what they do – that is, they are rewarded for good, beneficial acts, and penalized for poor, detrimental acts. If incentives are not well-aligned for accountability, the organization and its shareholders are poorly served.

To suspend judgment about all these matters – banks that are too big to fail, CEOs that get bonuses even as the organizations they run fall apart and are bailed out – is just not acceptable. Likewise, we cannot suspend judgment on any company that wants to take the rewards now and pass the risks on to others. If we all accept this as "how things are," we change the social contract. No longer is this a country where hard work and innovation and risk-taking is rewarded. It becomes a nation where being clever takes the place of being good.

CONTRACTS, CORPORATE SOCIAL RESPONSIBILITY, AND CAPITALISM

The Ideal Contract - our "Paradigm," versus the "Problematic Contract"

Most of us think we understand free markets. But do we, really? What is the essence of "free market" transactions? It is about contracting: contracting without government interference, in freely chosen ways – that is, with knowing, voluntary consent. And, as mentioned just above, reaping the rewards along risking financial ruin.

The Horse Trading Paradigm

To think about markets, we often resort to homely examples, the kind we find in early common law contracts cases. My contracts professor at Duke, F. Hodge O'Neill, used to give us examples of negotiations over "Dobbin" (a horse, not Dobby the house-elf in Harry Potter). Horse trading! What a great metaphor: I get to look over the horse, examine his mouth (if I have a way with horses), his hooves (careful, now!), his hide, and perhaps even take him for a ride. If I haven't investigated thoroughly, I may "lose" by getting a horse that is not adequate for my needs. If you have underpriced Dobbin, I get a good deal. Perhaps my expertise in horses pays off, and you pay the price for not knowing the value of what you had. This is all well and good.

Five Factors that Undermine the Paradigm

But the problem is that this "paradigm" (using horse trading as a model of "how things work" in a free market) is far too simple. Chances are, you already have a sense of this in the contracts cases you have studied this year. Why is this? There are a number of factors that make the paradigm too simple:

1. The size of the parties to the contract. Think of "big vs. little." Your bank, for example, and you. How about those ATM fees at away from your home bank? Can you negotiate that, or is it usually a "take it or leave it" deal? (That is, your choice is limited to choosing one very large company or another, all of whom have some differences, but where it's hard to discover where you can get the best "deal.") Can you find a small bank that you can actually negotiate with?

2. Sophistication of parties to the contract. Many parties to a contract negotiation are mismatched in terms of size, but also in terms of sophistication. A larger entity (your national bank, for example, or your credit card provider) is much more sophisticated in legal matters – it has hired legions of lawyers, accountants, and marketers to make your contracts lengthy, dense, and hard to understand. Yes, you have a "choice" – you can choose bank X with its lengthy, dense, and hard to understand contracts, or bank Y, with its own lengthy, dense, and hard to understand terms. You can also choose to put your money in a mattress.

3. Complexity of the product or service. Many things we buy nowadays are not like a hat, a book, or even a horse, but are complex products that we cannot fully understand without being a specialist. This MacBook, for example, has

inner workings that defy my understanding. I could only trust the brand, and what others say about it after many years, before switching from the PC world to the Mac world. If I am getting an adjustable rate mortgage from a mortgage broker, however, the situation is more complex. What brand can I trust? How can I find time to research all the different possibilities? Can I examine all the paperwork well before the signing? Will I possibly know what I am signing? Can I trust the "professionals" that advise me? Will I have to pay someone just to understand what kind of deal I am getting? And can I afford their services, assuming I can trust them?

4. Repetition of bargaining. In a one-off situation, the parties have a tendency to play the "defect" position in a prisoner's dilemma game. The more you deal with someone else, the more likely it is that you can have a relationship where cooperation is more likely than defection. But size, factor #1, comes into play: they may be so big that they literally don't care whether they keep YOU as a customer, as long as their total numbers are good, and they may be part of an oligopoly where all the "bigs" offer the same sorts of unfavorable deals, and you effectively don't have much of a choice.

5. Effectiveness of monitoring, enforcement, and dispute resolution. Where your claims of contract breach (or tort damages) are relatively small, a larger party can simply take advantage of you, because no effective legal representation is available. (See the *AT & T v. Concepcion* case, below.) Regulators have developed a habit of being "captured" by those they are supposed to regulate, so that real protection against polluters, scam artists like Bernie Madoff, and others is insufficient. (Think of the Mining and Minerals Service in their lack of regulatory oversight of BP's Deepwater Horizon well in the Gulf of Mexico.)

The Beauty of the Paradigm Case

In the horse-trading model of contracting, there are also some key assumptions that economists (for good reason) love. We assume a number of important background conditions for the negotiation leading to a contract to buy or sell a horse. These are the very conditions that, if writ large, would create an economy that is highly competitive, efficient, and fair.

1. There are many buyers and sellers. No one has a monopoly in horse selling; no one has a monopoly in horse buying. [If I don't want to deal with you and your horse, Dobbin, I have plenty of other horse owners to talk to; likewise, I'm not the only one buying horses right now.]

2. There are no negative externalities. [I can buy this horse, and you can sell this horse, and no one else is adversely affected.}

3. There is good (or perfect) information available on what is being bought and sold. [You are willing to show me Dobbin's pedigree, and I can examine him personally, and have my favorite veterinarian do so, as well.]

4. All buyers and sellers in the market are free to enter the market or leave it. [You and I don't need to even BE in the market to buy or sell a horse.]

5. All buyers and sellers are utility maximizers; each participant in the market tries to get as much as possible for as little as possible. [The price we come to will be fair, given all these other conditions, because we are both rational and wish to maximize the "good" to each of us.]

6. There are no parties, institutions, or governmental units regulating the price, quantity, or quality of any of the goods being bought and sold in the market. [The government is not giving me a tax deduction to buy a horse this year to help limit fossil fuel emissions from my car! You are not being subsidized by the government in any way – through tax incentives or otherwise – to raise horses or sell them, or to NOT raise horses or sell them.]

In short, our paradigm of horse trading works so very well. We "get it," and it really is a good model in terms of reinforcing virtuous, ethical behavior: it's rational, voluntary, consensual, fair, it doesn't hurt others in any way. But, take a look at the following chart, and see how the paradigm is actually a very small portion of the world of contracts today.

Looking at the chart below can help us understand that our simple paradigm tends to balance equality of bargaining position, liberty of the contractors, efficient outcomes, and also embraces community (negotiation, discourse, win/win situations), but that this paradigm is just a small piece of the overall picture of how contracting is done in our society today.

More on that very soon, but let's acknowledge that many contracts in our daily lives still seem like they fit the comfortable paradigm of horse-trading. I can choose many kinds of jeans, from many kinds of retailers. I can go online, or to a "bricks and mortar" retailer. Even so, also deviates from the horse-trading paradigm. Why? Because unlike a horse, a pair of jeans has gone through many processes that are mostly hidden to you or me: the growing of the cotton, the weaving operations, the dying operations, the workers who may or may not be working in horrid conditions, etc. Two "identical" looking pairs of pants may in fact be very different in their impacts on earth, people, and communities. You could buy "earth-friendly" jeans (that use organic cotton) "worker friendly" jeans(paying a living wage and benefits to workers), or just go for the lowest price with the "best" television or print marketing, so that you are really "cool."

(See letter E. below, on sustainability, p. 31).

So, even seemingly simple kinds of contracts are not exactly like "horse trading," and many are not at all like the paradigm of horse trading. Those that *are* fit into the shaded (colored) area in the chart below:

A. Size of and bargaining power of contractor	Small (A.1)	Medium (A.2)	Large (A.3)

B. Complexity of subject and terms of agreement	Simple (B.1)	Somewhat dense or confusing (B.2)	Deliberately complex (B.3)
C. Sophistication of parties	Unsophisticated (C.1)	Somewhat Sophisticated (C.2)	Very sophisticated (C.3)
D. Repetition of contractual process	One-off (D.1)	Often (D.2)	Continuous (D.3)
E. Effectiveness of third party monitoring, availability& effectiveness of criminal process for fraud	Absent (E.1)	Intermittent (E.2)	Continuously effective (E.3)

Those interactions that are most likely to challenge the ideal exchange are these:

A.3 dealing with A.1 (individual or small business) who is relatively unsophisticated (C.1), in an exchange involving complex matters where there is little or no effective law (E.1) to protect the smaller party. [The imbalance is even worse where the larger party – or an agent for the large company – is not expecting to, needing to, or motivated to do business with the smaller party more than once, or knows that A.1 is limited in their effective choices.]

Unfortunately, this prevalence of this model for important contractual exchanges has increased in recent years in the United States.

Example: fraudulent sales of mortgages to homeowners in Florida. See Matt Taibbi, *Rolling Stone*, Nov. 10, 2010. Courts Helping Banks Screw Over Homeowners.

If you read nothing else after exams and before New Year's Day, read this article from Rolling Stone.

Website:

http://www.rollingstone.com/politics/news/17390/232611

Other examples of are plentiful.

<u>See also</u>: *AT & T Mobility v. Concepcion*
http://www.scotusblog.com/case-files/cases/att-mobility-v-concepcion/

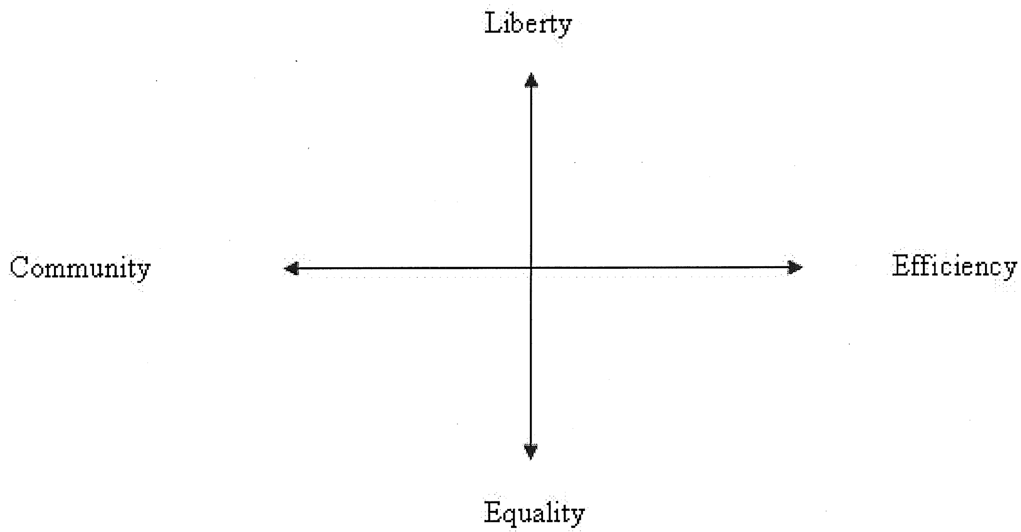
What you see in the facts of *Concepcion* is a very large company – or, perhaps more realistically, some agent or group within the company – taking advantage of the company's size and sophistication to force an "agreement" that is not voluntary, consensual, and knowing. In *Concepcion,* AT & T Mobility advertised a "free phone" but charged $33 in sales tax. A small charge, but unfair; deceitful, in essence. $33 is not the same as "free." The buyer wanted to rescind, or get the charge revoked, but was rebuffed. The same deceit was practiced on thousands of customers, but AT & T's contract specified that all claims had to be individually arbitrated, and could not be litigated, and no class action arbitrations could be brought. Given the very small amount being "extracted" by AT & T, the contract deliberately deprived the Concepcions – and any other customer – of any realistic remedy: no attorney would take a case to recover $33.

See also <u>Marketplace</u>, Thurs., Nov. 24, showing the power of banks to command fees from consumers greatly in excess of what the services cost them.

http://marketplace.publicradio.org/display/web/2010/11/24/am-why-are-outofnetwork-atm-fees-so-high/

* * *

This kind of imbalance poses significant challenges to the legal system. Jim O'Toole, my colleague at the University of Denver, came up with what is called The Executive's Compass. With permission, his diagram on the four points of the Compass is reproduced here:



Historically, most public policy (law, court decisions, etc.) is a compromise between these four competing conceptions of "the good." Most societies come to public policy and law at a point somewhere in the northeast quadrant. Our own society has gone more towards liberty and less toward equality at certain points, and more toward efficiency and less toward community at certain points. That is, in social-political terms, we make choices as a community as to which points of the compass we favor. No community or state embraces one value to the exclusion of all others, although Maoist China came pretty close in greatly favoring equality over liberty, and Victorian England came pretty close as to decisively favoring liberty over equality what we now call laissez-faire capitalism. The imperatives of efficiency can be chosen over community values, as where large corporations and institutions are favored over the rights and well-being of common people. This happened in Nazi Germany. In too-big-to-fail, our government held its nose and opted for an efficient solution that favored the most powerful and politically entrenched constituencies. No wonder we are in a kind of social contract crisis: many people, on all parts of the political spectrum, sense a need for the point on the Compass to move back toward community.

Our dealings with banks, cellular providers, your student loans, investment banks and financial advisors, health care, the legal system itself, your credit cards, are ever increasingly impersonal – getting a real person on the other end of the telephone when there's a problem isn't getting any easier – yet the products, services, and problems have become increasingly complex. The legal system must somehow balance the complexity of modern industrially efficient society with real people who don't have the sophistication or size to be on a level playing field. To answer questions in your text such as "Did the courts make the right and ethical decision," we should ask ourselves how well the courts have dealt with these imbalances of power; that's essentially a "distributive justice" question (see page ___ of your text, and pp. ___ in this handout). See also B., p. 32 below.

EXAMINING CONTRACT CASES: A METHOD FOR ETHICAL ANALYSIS

Two kinds of questions often appear after your cases. Did the court act fairly/ethically? Did the parties act ethically? We'll come back to the courts (and the laws as enforced by the government) in a moment. Let's look at "parties" to a contract and how we could think about whether they acted ethically.

Pre-Contract Decisions

We have already looked at one pre-contract situation and assessed the ethical dimensions of it. Sam Colt's decision (should he withhold important information and "do the deal," or be completely honest?) was examined using several ethical frames. Sam's non-disclosure flunks the Friedman test, flunks the deontological test, and flunks the virtue ethics test. He flunks the social contract test as well; h wants the reward, but passes the risk to someone else. [On some levels, this makes the decision "easy." He can get the bonus and not personally be affected. But if being ethical were easy, we'd all be doing it, and we wouldn't be talking about it.] Although the text made a weak argument that "going for the deal" might be justified on utilitarian grounds, closer examination reveals that it cannot be.

So, for pre-contract decisions, just see if there are any ethical perspectives that would justify the party's decision/action. Two general rules: if virtue ethics and deontology do not support the decision/proposed action, it is probably wrong. Also, if a course of action is unjustified on any ethical perspective other than utilitarianism, take a good, hard look at the utilitarian "justification." Chances are you will find a weak justification, if any.

Many cases involve both pre and post contract decisions. For example, look at the "Curves" case, on page 251. McOskar Enterprises decides to get customers to waive any claims of negligence. It saves money in doing this. How should we evaluate this?

1. Are all of the facts clear? Are there other facts that, if known, would be relevant to judging the ethical quality of the decisions made? (e.g., had similar problems arisen in the past? What would it cost McOskar to get enough insurance to pay for negligence claims, and how much would that trim profits? Is this "greed," or "business necessity"? Do they hire sufficiently trained people so that the likelihood of Ms. Anderson's unfortunate injuries is minimized? If not, why not?]
2. Who are the stakeholders? (here, McOskar Enterprises, the customers, the plaintiff. . . .)
3. What are the options that they have? (to include an exculpatory clause, or not to, but also, what is their business model, and why not insurance rather than an exculpatory clause? Sometimes the facts will just not be known, so you can make up something that sounds realistic and reasonable.)
4. What ethical perspectives support their preferred option? That is, how can they "justify" this decision? [Is this a decision that has support in ethical perspectives?][What would Friedman say? What would a utilitarian say? What would a deontologist say? What would a virtue ethics person say? What does the social contract suggest?*]
5. What ethical perspectives support their less preferred option?
6. Why do you think they chose the option they did?
7. Would you have chosen differently? Why, or why not?

* If "Curves for Women" really cares about women, what would their business model look like? If they have such a contract provision, do they point it out? Do they make sure that the client has adequate insurance in case of negligence causing harm to a client? Is it deceitful not to? Would it be virtuous to do so? What would Kant say?

Post Contract Decisions

You could also look at the Curves case in terms of post-dispute ethics. After Mrs. Anderson asked for money from the company, what was their response? What "should" have been their response, ethically? Why? Why do you think they responded to her as they did (and why, if there was a "more ethical" option, did they not choose that?) Should they change their business model? (Are they operating in what Mackey calls "conscious capitalism?" Should they?

Did the Courts decide ethically?

This is the most difficult question, but it *is* approachable. If the court "followed the law," the question is translatable to "does the law as applied make sense ethically?" There are at several "lenses" or frameworks in which to view this question.

A. Does the decision encourage or discourage ethical decisions and ethical actions? Explain in terms of deontology (does the announced rule "fit" with other, universalizable rules) and virtue ethics (does the decision encourage trustworthiness, caring, responsibility, fairness, and respect?), as well as social contract (your understanding of the social/legal/political system that supports free enterprise, including (1) freedom of choice, (2) voluntary, knowing consent (3) accountability for one's actions – the right linkage between risk and reward, and (4) absence of fraud or deceit?

B. Is the decision within an appropriate frame for the Executive's Compass – does it adequately balance freedom with equality, and efficiency with community?

C. Is the decision (or the law behind it) consistent with the basics of economic theory as applied to a competitive free market economy? (This might apply more to antitrust litigation, securities litigation, regulatory or administrative law, and environmental law than to contracts) Does it recognize the need for many buyers and sellers, good information, no negative externalities, sufficient public goods, and few barriers to entry?

D. Is the law supportive of "conscious capitalism"?

E. Sustainability. A fifth "lens," well beyond the scope of this discussion of "ethics in contracting," is the sustainability lens. The supply chain, for most products, is a whole series of enterprises, from extraction, to production, to marketing, to consumption, to disposal. Given the state of Planet Earth today, our role as consumers (contracting for "goods") is critical. If you haven't seen it, I recommend "The Story of Stuff." It's only 20 minutes long, but long on a vital perspective we don't get from the media.

http://www.storyofstuff.com/