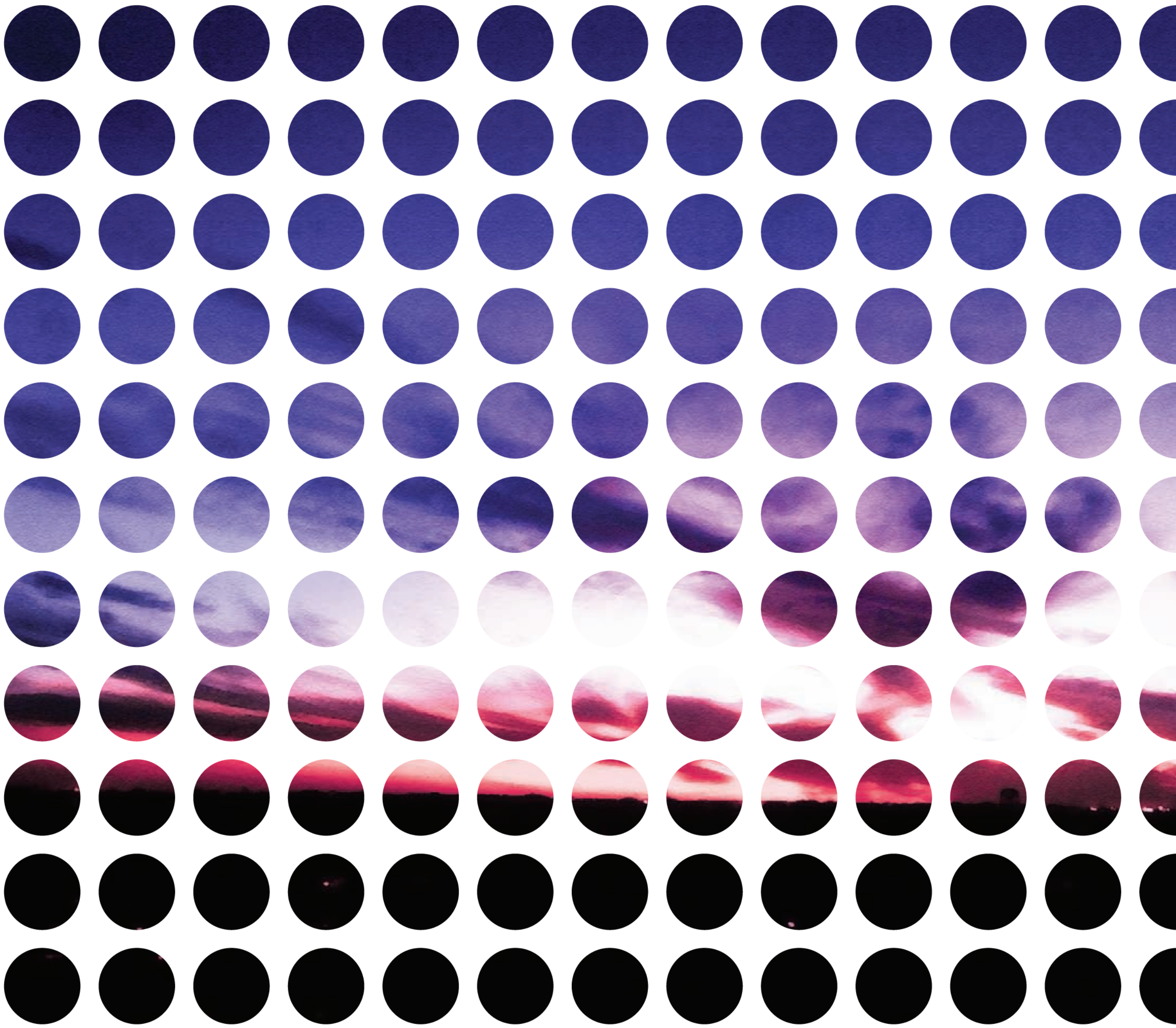

Pearson New International Edition

Ethics and the Conduct of Business

John R. Boatright

Seventh Edition

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Merck and the Marketing of Vioxx

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

For decades, Merck's stellar reputation rested on the company's emphasis on science-driven research and development. Merck employed some of the world's most talented and best-paid researchers and led other pharmaceutical firms in the publication of scientific articles and the discovery of new medicines for the treatment of serious conditions that lacked a satisfactory treatment. For seven consecutive years in the 1980s, Merck was ranked by *Fortune* magazine as America's most respected company. Merck received widespread accolades in particular for the decision, made in 1978, to proceed with research on a drug for preventing river blindness (onchocerciasis), which is a debilitating parasite infection that afflicts many in Africa, even though the drug was unlikely to pay for itself. Eventually, Merck decided to give away the drug, called Mectizan, for as long as necessary at a cost of tens of millions of dollars per year. This kind of principled decision making was inspired by the words of George W. Merck, the son of the company's founder: "We try never to forget that medicine is for the people. It is not for the profits. The profits follow, and if we have remembered that, they have never failed to appear. The better we have remembered it, the larger they have been."

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

The success of Vioxx came at a critical time for Merck. Not only were the patents on several profitable drugs due to expire, opening the way for generic competition, but also the competitive environment of the entire pharmaceutical industry was undergoing rapid change. Competition from generic drugs increased dramatically due to federal legislation and also due to the rise of large, powerful managed care organizations, which sought to cut the cost of drug treatments through the use of formularies that restricted the drugs doctors could prescribe. The development of new drugs was increasingly shifting to small entrepreneurial research companies focused on specific technologies, which reduced the competitive advantage of the traditional large pharmaceutical firms. Merck's competitors responded to changes in the competitive environment by acquiring small companies, developing new products that duplicated ones already on the market (so-called "me-too" drugs), entering the generics market, seeking extensions of patents after making only slight improvements, and engaging in aggressive marketing, including the use of controversial direct-to-consumer (DTC) advertising.

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

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

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

In the meantime, Merck continued its aggressive marketing campaign. Between 1999 and 2004, Merck spent more than $500 million on DTC television and print advertising. This expenditure was intended to keep pace with the heavy spending by Pfizer for its competing COX-2 inhibiter Celebrex. Merck also maintained a 3000-person sales force to meet with doctors for face-to-face conversations about Vioxx. To support this effort, Merck developed materials that provided salespeople with responses to questions from skeptical physicians.[3] One document, called an "obstacle handling guide," advised that questions about the risk of heart attacks be answered with the evasive explanations that Vioxx "would not be expected to demonstrate reductions" in heart attacks and was "not a substitute for aspirin." Another document titled "Dodge Ball Vioxx" concluded with four pages that were blank except for the word "DODGE!" in capital letters on each page. Company documents also describe an effort to "neutralize" skeptical doctors by enlisting their support or at least defusing their opposition by offers of research support or engagements as consultants.[4]

The study that conclusively established that Vioxx increased the risk of heart attacks was called APPROVe (Adenomatous Polyp Prevention on Vioxx), which, according to critics, had only a marketing and not a legitimate scientific purpose.[5] Although the company could have delayed the withdrawal until ordered to do so by the FDA, Merck acted voluntarily. Gilmartin said that the company "was really putting patient safety first." [6] However, one critic replied, "If Merck were truly acting in the interest of the public, of course, they should have done more studies on Vioxx's safety when doubts about it first surfaced."[7] Another critic observed that such studies could have been conducted for a fraction of the cost of the $500 million spent on advertising.[8] An editorial in the *New York Times* declared that "companies must jump at the first hint of risk and warn patients and doctors of any dangers as clearly and quickly as possible. They should not be stonewalling regulators, soft-pedaling risk to doctors or promoting drugs to millions of people who don't need them."[9] A 179-page report commissioned by the Merck board concluded, by contrast, that executives and researchers acted with integrity in addressing incomplete and conflicting evidence and that "their conclusions were reached in good faith and were reasonable under the circumstances."[10] The report closed with the observation that the quick response after the APPROVe study "is not consistent with the view that Merck's corporate culture put profits over patient safety."[11]

INTRODUCTION

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

All business organizations face the daunting challenge of adhering to the highest standards of ethics while, at the same time, remaining competitive and providing the products and services that the public demands. The task of managers in these organizations is to make sound business decisions that enable a company to achieve its mission. Some of these decisions involve complex ethical issues that may not be readily apparent, and success in making sound business decisions may depend on understanding these ethical issues and resolving them effectively. This text is about the ethical issues that arise for managers—and, indeed, for all people, including employees, consumers, and members of the public. Corporate activities affect us all, and so the ethical conduct of business is a matter of concern for everyone. The ethical issues examined in this text are those considered by managers in the ordinary course of their work, but they are also matters that are discussed in the pages of the business press, debated in the halls of Congress, and scrutinized by the courts. This is because ethical issues in business are closely tied to important matters of public policy and to the legislative and judicial processes of government. They are often only part of a complex set of challenges facing the whole of society.

BUSINESS DECISION MAKING

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

1. *The Sales Rep.* A sales representative for a struggling computer supply firm has a chance to close a multimillion-dollar deal for an office system to be installed over a two-year period. The machines for the first delivery are in the company's warehouse, but the remainder would have to be ordered from the manufacturer. Because the manufacturer is having difficulty meeting the heavy demand for the popular model, the sales representative is not sure that subsequent deliveries can be made on time. Any delay in converting to the new system would be costly to the customer; however, the blame could be placed on the manufacturer. Should the sales representative close the deal without advising the customer of the problem?

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

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

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

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

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

Two Distinguishing Features

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

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

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

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

Levels of Decision Making

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

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

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

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

CASE 2 Explore the Concept on mythinkinglab.com

The Ethics of Hardball

Toys "R" Us: Fair or Foul?

Hardball tactics are often applauded in business, but when Child World was the victim, the toy retailer cried foul.[13] Its complaint was directed against a major competitor, Toys "R" Us, whose employees allegedly bought Child World inventory off the shelves during a promotion in which customers received $25 gift certificates for buying merchandise worth $100. The employees of Toys "R" Us were accused of selecting products that Child World sold close to cost, such as diapers, baby food, and infant formula. These items could be resold by Toys "R" Us at a profit, because the purchase price at Child World was barely above what a wholesaler would charge, and then Toys "R" Us could redeem the certificates for additional free merchandise, which could be resold at an even higher profit. Child World claimed that its competitor bought up to $1.5 million worth of merchandise in this undercover manner and received as much as $375,000 worth of gift certificates. The practice is apparently legal, although Child World stated that the promotion excluded dealers, wholesalers, and retailers. Executives at Toys "R" Us did not deny the accusation and contended that the practice is common in the industry. Child World may have left itself open to such a hardball tactic by slashing prices and offering the certificates in an effort to increase market share against its larger rival.

Home Depot: Good Ethics or Shrewd Business?

When weather forecasters predicted that Hurricane Andrew would strike the Miami area with full force, customers rushed to stock up on plywood and other building materials.[14] That weekend the 19 Home Depot stores in southern Florida sold more 4-foot-by-8-foot sheets of exterior plywood than they usually sell in two weeks. On August 24, 1992, the hurricane struck, destroying or damaging more than 75,000 homes, and in the wake of the devastation, individual price gougers were able to sell basics like water and food as well as building materials at wildly inflated prices. But not Home Depot. The chain's stores initially kept prices on plywood at pre-hurricane levels, and when wholesale prices rose on average 28 percent, the company announced that it would sell plywood, roofing materials, and plastic sheeting at cost and take no profit on the sales. It did limit quantities, however, to prevent price gougers from reselling the goods at higher prices. In addition, Home Depot successfully negotiated with its suppliers of plywood, including Georgia-Pacific, the nation's largest plywood producer, to roll back prices to pre-hurricane levels. Georgia-Pacific, like Home Depot, has a large presence in Florida; the company runs 16 mills and distribution centers in the state and owns 500,000 acres of timberland. Although prices increased early in anticipation of Hurricane Andrew, Home Depot was still able, with the cooperation of suppliers, to sell half-inch plywood sheets for $10.15 after the hurricane, compared with a price of $8.65 before, thereby limiting the increase to less than 18 percent. Home Depot executives explained their decision as an act of good ethics by not profiting from human misery. Others contend, however, that the company made a shrewd business decision.

ETHICS, ECONOMICS, AND LAW

Businesses are economic organizations that operate within a framework of law and regulation. They are organized primarily to provide goods and services, as well as jobs, and their success depends on operating efficiently and competitively. In a capitalist system, firms must compete effectively in an open market by providing goods and services that customers want and by doing so at a low price, which is possible only when the desired goods and services are produced efficiently. Profit is not the end or purpose of business, as is commonly asserted, but is merely the return on the investment in a business that is possible only when the business is competitive. Business has often been described as a game, in which the aim is to make as much profit as possible while staying within the rules of the game, which are set mainly by government through laws and regulations.[15] On this view, profit is a measure and the reward of success, but it cannot be gained without also aiming to be competitive. Moreover, it is necessary, in pursuing profits, to observe certain ethical standards, as well as laws and regulation, as a means to the end of profit making.

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

The Relationship of Ethics and Economics

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

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

JUSTIFICATION OF THE MARKET SYSTEM. The argument for this position, that economic actors ought to make utility-maximizing choices, is the classical defense of the market system. In *The Wealth of Nations*, Adam Smith, the "father" of modern economics, justified the pursuit of self-interest in exchange on the grounds that by making trades for our own advantage, we promote the interests of others. The justification for a free-market capitalist system is, in part, that by pursuing profit, business firms promote the welfare of the whole society. Commentators on Adam Smith have observed that this argument assumes a well-ordered civil society with a high level of honesty and trust and an abundance of other moral virtues. Smith's argument would not apply well to a chaotic society marked by pervasive corruption and mistrust. Furthermore, in his defense of the free market in *The Wealth of Nations*, Smith was speaking about *exchange*, whereas economics also includes *production* and *distribution*.[16] The distribution of goods, for example, is heavily influenced by different initial endowments, access to natural resources, and the vagaries of fortune, among other factors. Whether the vast disparities in wealth in the world are justified is a question of distribution, not exchange, and is not addressed by Smith's argument.

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

SOME CONDITIONS FOR FREE MARKETS. A common view is that ensuring the conditions for free markets and correcting for their absence is a job for government. It is government's role, in other words, to create the rules of the game that allow managers to make decisions solely on economic grounds. However, the task of maintaining the marketplace cannot be handled by government alone, and the failure of government to do its job may create an obligation for business to help. Although government does enact and enforce laws against theft and fraud, including such specialized forms as the theft of trade secrets and fraud in securities transactions, there are many gray areas in which self-regulation and restraint should be exercised. Hardball tactics like those allegedly employed by Toys "R" Us (Case 2) are apparently legal, but many companies would consider such deliberate sabotage of a competitor to be an unacceptable business practice that is incompatible with the market system.

Recent work in economics has revealed the influence of ethics on people's economic behavior. Economists have shown how a reputation for honesty and trustworthiness, for example, attracts customers and potential business partners, thus creating economic opportunities that would not be available otherwise. Similarly, people and firms with an unsavory reputation are punished in the market. People are also motivated in their market behavior by considerations of fairness. This is illustrated by the "ultimatum bargaining game," in which two people are given a certain amount of money (say $10) on the condition that one person proposes how the money is to be divided (e.g., $5 to each) and the second person accepts or rejects the proposed division. The first person can make only one proposal, and if the proposal is rejected by the second person, the money is taken away and each person receives nothing. Economic theory suggests that the second person would accept any proposal, no matter how small the share, if the alternative is no money at all. Hence, the first person could offer to share as little as $1 or less. But many people who play the game will refuse a proposal in which they receive a share that is considered too small and hence unfair.[17] They would rather have nothing than be treated unfairly.

Economists explain the behavior of companies like Home Depot (Case 2) by the fact that considerations of fairness force firms to limit profit-seeking behavior. Consumers remember price gouging and other practices that they consider unfair and will punish the wrongdoers by ceasing to do business with them or even by engaging in boycotts. One study found that people do not believe that scarcity is an acceptable reason for raising prices (despite what economists teach about supply and demand),[18] and so Home Depot and Georgia-Pacific, which are there for the long haul, have more to lose than gain by taking advantage of a natural disaster. Evidence also indicates that people in a natural disaster feel that everyone ought to make some sacrifice, so that profit seeking by a few is perceived as shirking a fair share of the burden.[19]

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

The Relationship of Ethics and the Law

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

TWO SCHOOLS OF THOUGHT. One school of thought is that law and ethics govern two different realms. Law prevails in public life, whereas ethics is a private matter. The law is a clearly defined set of enforceable rules that applies to everyone, whereas ethics is a matter of personal opinion that reflects how we choose to lead our own lives. Consequently, it would be a mistake to apply ethical rules in business, just as it would be a mistake to apply the rules of poker to tennis. A variant of this position is that the law represents a minimal level of expected conduct that everyone should observe. Ethics, on the other hand, is a higher, optional level. It's "nice" to be ethical, but our conduct has to be legal.

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

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

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

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

First, the law is inappropriate for regulating certain aspects of business activity. Not everything that is immoral is illegal. Some ethical issues in business concern interpersonal relations at work or relations between competitors, which would be difficult to regulate by law. Taking credit for someone else's work, making unreasonable demands on subordinates, and unjustly reprimanding an employee are all ethically objectionable practices, but they are best left outside the law. Some hardball tactics against competitors may also be legal but ethically objectionable. Whether the effort of Toys "R" Us to sabotage a promotion by its competitor is acceptable behavior (see Case 2) is open to dispute, but not every legal competitive maneuver is ethical. Generally, legislatures and the courts are reluctant to intervene in ordinary business decisions unless significant rights or interests are at stake. They rightly feel that outsiders should not second-guess the business judgment of people closer to a problem and impose broad rules for problems that require a more flexible approach. Companies also prefer to handle many problems without outside interference. Still, just because it is not illegal to do certain things does not mean that they are morally okay.

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

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

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

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

ETHICS AND MANAGEMENT

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

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

Ethical Management and the Management of Ethics

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

The management of ethics is acting effectively in situations that have an ethical aspect. These situations occur in both the internal and external environments of a business firm. Internally, organizations bind members together through myriad rules, procedures, policies, and values that must be carefully managed. Some of these, such as a policy on conflict of interest or the values expressed by a company's mission statement, explicitly involve ethics. Effective organizational functioning also depends on gaining the acceptance of the rules, policies, and other guides, and this acceptance requires a perception of fairness and commitment. For example, an organization that does not "walk the talk" when it professes to value diversity is unlikely to gain the full cooperation of its employees. With respect to the external environment, corporations must successfully manage the demands for ethical conduct from groups concerned with racial justice, human rights, the environment, and other matters.

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

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

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

Ethics and the Role of Managers

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

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

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

We cannot understand the role obligations of managers without knowing more about their specific role. Managers serve at all levels of an organization—top, middle, and lower—and fulfill a variety of roles. Usually, these are defined by a job description, such as the role of a purchasing agent or a personnel director. Uncertainty arises mainly when we ask about the role of top managers, that is, high-level corporate executives who make key decisions about policy and strategy. The higher one goes in a business organization, the more roles one occupies. Many of the ethical dilemmas for top managers are due to conflicts between three main roles.

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

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

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

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

ETHICS IN ORGANIZATIONS

The manager who seeks to act ethically and to ensure the ethical conduct of others—which have been identified in this chapter as "ethical management" and "the management of ethics"—must have the ability not only to understand ethical issues and resolve them effectively but also to appreciate the challenges of ethical decision making and ethical conduct in an organizational setting. The fact that much business activity takes place in organizations has profound consequences for the manager's role responsibilities for several reasons.

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

Consequently, the typical case of wrongdoing in organizations involves missteps that are due more to inadequate thought than deliberate malice, where people get tripped up in a moral maze. The following two sections discuss the findings, mainly of psychologists and sociologists, about how ethical mistakes result from flaws in individual decision making and from organizational forces.

Individual Decision Making

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

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

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

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

A particularly common rationalization in business is "everybody's doing it." This retort may even justify some actions when refraining would put a company at a competitive disadvantage (when competitors engage in deceptive advertising, for example) or when business cannot be conducted without so acting (e.g., engaging in foreign bribery).[29] Other rationalizations include "No real harm is done" or "No harm no foul"; "I deserve this" or "They owe this to me" (sometimes used to justify pilfering); "It's for a good cause" (the ends justify the means); and "If I don't do this, someone else will" (restraint is futile; the consequences will happen anyway).

Sociologists who have studied crime, including the kind of white-collar crime that occurs in business, have described a process of rationalization they call "neutralization" that enables lawbreakers to deny the criminality of their behavior.[30] Among the techniques of neutralization are claims that one is not really responsible ("I was out of my mind"), that any real harm was done ("No one will miss that amount of money"), that the victim deserved the harm ("I was only paying him back"), that one's accusers are being unfair ("I'm being singled out for blame"), and that one was following some higher duty or loyalty ("I had to protect my friends"). All the rationalizations detailed here show the immense capacity of people to engage in self-deception.

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

Among the biases discovered by psychologists are the following:

- *Loss Aversion Bias*. People tend to weigh losses more heavily than gains and thus take greater risks to avoid losing something they have than to gain something that they do not have.
- *Framing Effect.* People's decisions depend on how the choices are presented or framed. Thus, the loss aversion bias leads people to choose alternatives that are framed in terms of losses rather than gains.
- *Confirmation Bias.* This is the tendency of people to seek and process information that confirms existing attitudes and beliefs instead of seeking and processing information that poses challenges to their attitudes and beliefs.
- *Cognitive Dissonance.* Related to the confirmation bias, cognitive dissonance is the tendency of people to dismiss information that would disrupt their existing attitudes and beliefs.
- *Commitment and Sunk Costs.* Once commitments are made and resources expended, people tend to persist in a course of action, even in the face of information that should lead them to reconsider their initial decision.
- *Hindsight Bias.* People tend to believe that events are more predictable than they are, and consequently they blame themselves for not anticipating events that occur.
- *Causation Bias and Illusion of Control.* People often find causal patterns in random events, which leads to the belief that they have a greater ability to control events than is warranted.
- *Overoptimism and Overcofindence Bias.* People are unduly confident of their own knowledge and abilities and thus overestimate the likelihood of success.
- *Self-interest Bias*. People tend to make judgments, especially about fairness, that favor themselves.
- *Risk Perception Bias.* People make poor judgments about risk, overestimating some risk and discounting others, often ignoring low-probability events and favoring certain over uncertain outcomes.

The main heuristics people employ are as follows:

- *Anchoring and Adjustment Heuristic.* People tend to form an initial choice ("anchor") early in the decision-making process and then adjust the choice in response to additional information. Thus, the final decision is heavily influenced by the initial choice, especially given that people often fail to make adequate adjustments.
- *Representativeness Heuristic.* This is the tendency of people to utilize recent and vivid examples rather than objective statistical data. For example, a person purchasing an automobile may rely on a friend's experience with one model instead of reading test reports.

- *Availability Heuristic.* People tend to make decisions based on the available information at hand rather than seeking out new sources of information. Information may be "available," for example, because it is more recent or vivid or because it is easier or more comfortable to remember.

These biases and heuristics have developed in the process of evolution to enable human beings to decide and act quickly, especially in dangerous situations with too much information to process fully. Generally, they serve us well but can lead to mistakes. They can cause us, for example, to fail to consider important consequences or what could go wrong, to discount the possibility of random events, to misidentify causes, to be overoptimistic or overconfident, and to favor people like ourselves. Psychologists have also noted that biases and heuristics prevent us from foreseeing disasters that we should have seen coming[33] and lead us to overlook the unethical conduct of others.[34] Instances of defective products, accounting fraud, and industrial accidents have been closely studied to reveal the psychological factors that explain how such bad decisions could have been made by decent, diligent, well-intentioned individuals.

Organizational Decision Making

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

Decision making in organizations is marked by four features that contribute to mistakes, big and small. First, major decisions are not made all at once with all their consequences and ramifications understood; rather they are made over time in a series of small steps, no one of which may raise any particular concerns. Second, as they are made over time, these multiple decisions develop a commitment to a course of action that is usually difficult to stop. Once a project is underway, there may be considerable sunk costs that cannot be recovered, and anyone who proposes a halt to a project bears a burden of proof to justify it, whereas little justification is needed to proceed with a project underway. Stopping a project also means that mistakes were made, which it may be difficult for managers to admit since someone must bear the blame. With commitment to a course of action also comes a psychological tendency to interpret evidence in ways that support one's beliefs and interests. This factor probably goes far toward explaining why Merck executives misinterpreted the results of the VIGOR study and concluded that they were due to the heart-protection benefit of naproxen and not to any harmful effect from Vioxx (see Case 1).

The third and fourth factors are the most important: These are the diffusion of information and the fragmentation of responsibility that occur in organizational decision making.[35] The information that would show that a product has a defect, for example, may exist within an organization in an unassembled form in which different facts are known to different individuals. However, unless this information is assembled and made known to at least one person, there may be no reason for anyone in the organization to conclude that a product is defective. Furthermore, information is distributed in organizations on a need-to-know basis, and each decision maker may have sufficient information for the decisions that that person makes. So unless one individual is specifically charged with discovering defects, no decision maker would typically have a reason to have access to all the information that would be necessary to reveal a defect.

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

Conclusion

Business ethics is concerned with identifying and understanding the ethical issues that arise in business and with developing the knowledge and skills needed by a practicing manager to address these issues and to make sound business decisions—that is, decisions that are sound from both an ethical and a business perspective. Ethical issues are an inevitable element of business decision making and are deeply intertwined with managerial practice and economic activity generally. Business ethics is important for managers because the ethical issues examined here are involved in many business decisions upon which the success of individual managers, business organizations, and, indeed, the whole economic system depend. Both economics and law are important guides for business decision making, but, as this chapter has shown, they are not complete. Nor is business ethics understood merely as the treatment of ethical issues from a philosophical perspective. As the work of psychologists and sociologists on organizational misconduct show, it is not enough merely to determine a right course of action. Misconduct in organizations is also the result of flaws in individual and organizational decision making that can be corrected only by changes in decision-making processes. Although this text deals mainly with the treatment of ethical issues in business, practicing managers must also address the larger challenge of preventing misconduct within organizations.

CASE 3 **Explore** the **Concept** on **mythinkinglab.com**

Beech-Nut's Bogus Apple Juice

When Lars Hoyvald joined Beech-Nut in 1981, the company was in financial trouble.[36] In the competitive baby food industry, the company was a distant second behind Gerber, with 15 percent of the market. After faltering under a succession of owners, Beech-Nut was bought in 1979 by Nestlé, the Swiss food giant, which hoped to restore the luster of the brand name. Although he was new to Beech-Nut, Hoyvald had wide experience in the food industry, and his aim, as stated on his résumé, was "aggressively marketing top quality products."

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

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

Fearful that state and federal investigators might seize stocks of Beech-Nut apple juice, Hoyvald launched an aggressive foreign sales campaign. On September 1, the company unloaded thousands of cases on its distributors in Puerto Rico. Another 23,000 cases were shipped to the Dominican Republic to be sold at half price. By the time that state and federal authorities had forced a recall, the plan was largely complete. In November, Hoyvald reported to his superior at Nestlé, "The recall has now been completed, and due to our many delays, we were only faced with having to destroy approximately 20,000 cases." Beech-Nut continued to sell bogus apple juice until March 1983.

CASE 4 **Explore** the **Concept** on **mythinkinglab.com**

KPMG's Tax Shelter Business

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

Acting like any business developing a new product, KPMG established a "Tax Innovation Center" to generate ideas and to research the accounting, financial, and legal issues.[37] Previously, tax shelters had been individualized for particular clients, but the new ones were intended to be generic, mass-marketed products. Once a strategy was approved, it was energetically promoted to likely clients by the firm's sales force. KPMG tax professionals were turned into salespeople. They were given revenue targets and urged to use telemarketing and the firm's own confidential records to locate clients. The strategies—which bore such acronyms as OPIS, BLIPS, FLIP, and SOS—generally involved complicated investments with cooperating foreign and offshore banks that generated phantom losses that could be used to offset capital gains or income from other investments. The shelters were accompanied by opinion letters from law firms that assessed their legality. The gain to KPMG and their clients and the loss to the U.S. Treasury were significant. The four main tax shelters marketed by the firm generated over $11 billion in tax deductions for clients, which yielded at least $115 million in fees for KPMG and cost the government $2.5 billion in lost tax revenue.[38]

During the period in which the KPMG tax shelters were sold, no court or Internal Revenue Service (IRS) ruling had declared them illegal. However, KPMG had failed to register the shelters with the IRS as required by law. Registration alerts the tax authorities to the use of the shelters and permits them to investigate their legality. One KPMG partner attributed this failure to a lack of specific guidance by the IRS on the rules for registration and the agency's lack of interest in enforcing the registration requirement.[39] Furthermore, this partner calculated that for OPIS, the firm would pay a penalty of only $31,000 if the failure to register were discovered. This amount was more than outweighed by the fees of $360,000 for each shelter sold.[40]

Until the courts or Congress explicitly outlaw a tax shelter, the line between legal and illegal tax strategies is often difficult to draw. The IRS typically employs the "economic substance" test: Do the transactions involved in a tax shelter serve a legitimate investment objective or is their only effect to reduce taxes? A tax shelter that offers no return beyond a tax saving is abusive in the view of the IRS. However, an IRS ruling is not legally binding until it is upheld by the courts, and the courts have occasionally held some shelters to be legal even if they do not involve any risk or potential return. One reason for such decisions is that tax shelters typically involve legitimate transactions combined in unusual ways. As one observer notes, "Most abusive shelters are based on legal tax-planning techniques—but carried to extremes. That makes it hard to draw sharp lines between legitimate tax planning and illicit shelters."[41] Even when a shelter like those sold by KPMG is found to be legal, a tax savings is almost always the only outcome. According to an IRS commissioner, "The only purpose of these abusive deals was to further enrich the already wealthy and to line the pockets of KPMG partners."[42]

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

Although some partners at KPMG thought that the tax shelters were illegal and raised objections, others argued for their legality—and, in any event, their shelters were an immensely profitable part of the firm's business. Aside from the huge fees, the motivation to market the shelters came from the KPMG culture, which *New York Times* business reporter Floyd Norris characterized as that of a "proud old lion." He writes, "Of all the major accounting firms, it was the one with the strongest sense that it alone should determine . . . the rules it would follow. Proud and confident, it brooked no criticism from regulators."[43]

Notes

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10. Martin Report, p. 177.
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20. Lynn Sharp Paine, "Law, Ethics, and Managerial Judgment," *Journal of Legal Studies Education*, 12 (1994), 153–69.
21. This phrase is taken from Norman E. Bowie, "Fair Markets," *Journal of Business Ethics*, 7 (1988), 89–98.
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23. See Thomas Donaldson, "Values in Tension: Ethics Away from Home," *Harvard Business Review*, 4 (September–October 1996), 48–62.
24. David Luban, Alan Strudler, and David Wasserman, "Moral Responsibility in the Age of Bureaucracy," *University of Michigan Law Review,* 90 (1991–92), 2366.
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Ethical Decision Making

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CASE 1 **Explore** the **Concept** on **mythinkinglab.com**

HP and the Smart Chip

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

Despite HP's claim to be providing a "free user-friendly tool," some customers took a different view of the smart chip. Users of HP ink-jet printers complained that the smart chip was programmed to send a premature low-on-ink (LOI) message, while substantial ink remained in the cartridge. They also contended that the smart chip would render a cartridge inoperable after a predetermined shutdown date that is not disclosed to users. This date was usually the earlier of 30 months after the initial installation or 30 months after the "install-by" date. In some instances, a cartridge could shut down even before it had been installed. Although HP cartridges carry a warranty, the warranty does not apply, among other conditions, for "products receiving a printer generated expiration message." The smart chip also guides users to HP's own Web store, where they may order a new cartridge. Once the smart chip had shut down a cartridge, it could not easily be refilled, thus requiring replacement with a new one. (The European Union has prohibited manufacturers from installing smart chips in cartridges in an effort to promote recycling. Indeed, the European Parliament uses only recycled cartridges.) The HP promotional materials, users' manuals, and packaging reveal little about the features of the smart chip. The box containing a cartridge generally lists the date of the warranty expiration but not any shutdown date. In an issue unrelated to the smart chip, some users were disconcerted to learn that certain color ink-jet printers used colored ink when printing in black and white in a process known as "underprinting" or "under color addition," which resulted in more rapid depletion of colored ink. This feature, too, was not commonly disclosed.

When several separate suits were filed between 2005 and 2008 (the courts denied requests for class-action status), HP vigorously defended its practices, denying that it had done anything wrong or improper. The company contended that, overall, the smart chip provided a helpful service to users and ensured a better printing experience. The smart chip was necessary, the company explained, to enable users to monitor ink levels and be prepared when a replacement was needed. In any event, the monetary loss to customers was minor compared with the convenience. The smart chip was also beneficial to HP since replacement cartridges provided approximately half of the revenues of the Imaging and Printing Group, and "consumables" of all kinds generated approximately 10 percent of HP's total revenue. Typically, printers, like razor holders, are sold at very low cost since the profits lie mainly in the products that go with them. The profit margin on HP's ink and toner cartridges ranged between 50 and 60 percent.

Despite the denials of any wrong or improper conduct, HP agreed in 2010 to settle the suits, which were consolidated into one. In the settlement, HP agreed to state in all on-screen messages, manuals, and other information that the ink-level information is an estimate only, that actual ink levels may vary, and that the customers need not replace a cartridge until the print quality is no longer acceptable. HP also agreed to explain on its website and in manuals the use of expiration dates and underprinting and also to explain how underprinting may be minimized or eliminated. Finally, HP agreed to set aside $5 million to provide e-credits to customers who had purchased certain printers and cartridges. These e-credits, which ranged in amounts from $2 to $6 depending on the printer in question, could be applied only in the HP online store. The settlement did not address the use of the smart chip, and it continues to be used by HP and many other manufacturers.

INTRODUCTION

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

In order to identify what makes acts right and wrong and to determine what we ought to do or what our duties and responsibilities are in particular cases, it is necessary to understand the elements of ethical decision making. What rules or principles apply to business practice? This chapter answers this question by dividing business ethics into two parts. The first part considers the ethics of the marketplace in which two parties, a buyer and a seller, come together to trade or make an exchange. Although simple in concept, such market transactions are governed by a host of rules or principles that constitute a market ethics. As prominent as market transactions are to business, much business activity also involves roles and relationships, such as the role of an employee and the employer–employee relationship, which are more than mere market transactions. The second part