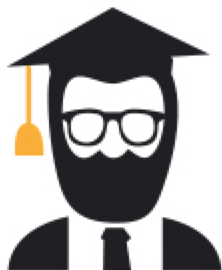

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Self-Interest and Business Ethics: Some Lessons of the Recent Corporate Scandals

Thomas L. Carson

ABSTRACT. The recent accounting scandals at Enron, WorldCom, and other corporations have helped to fuel a massive loss of confidence in the integrity of American business and have contributed to a very sharp decline in the U.S. stock market. Inasmuch as these events have brought ethical questions about business to the forefront in the media and public consciousness as never before, they are of signal importance for the field of business ethics. I offer some observations and conjectures about the bearing of the recent scandals on the literature on business ethics. I defend the following contentions:

1. Recent events reveal serious weaknesses of the stakeholder theory about the social responsibilities of business which lacks prohibitions against fraud and deception. This is a glaring deficiency of standard versions of the stakeholder theory, but it is easily remedied by adding explicit prohibitions against fraud and deception. In addition, recent events highlight the stakeholder theory's very naive and unrealistic hopes and expectations for business executives as moral arbiters and agents of social improvement.
2. Recent events do not constitute an objection to the shareholder theory about the social responsibilities of business, however, these events make evident the implausibility of strong versions of the invisible hand theory.
3. Schemes of payment and reward often create perverse incentives for individuals to engage in unethical conduct.
4. Both the shareholder theory and the stakeholder theory need to add a constraint that requires executives to respect the professional obligations of employees.

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Introduction

The recent corporate accounting scandals at Enron, WorldCom, and other corporations have helped to fuel a massive loss of confidence in the integrity of American business and have contributed to a very sharp decline in the U.S. stock market. Inasmuch as these events have brought ethical questions about business to the forefront in the media and public consciousness as never before, they are of signal importance for the field of business ethics. None of us has the wisdom or the historical distance on these events to offer a final assessment of their significance. I offer here some brief observations and conjectures about the bearing of recent events on the literature on business ethics. I defend the following contentions:

1. Recent events reveal serious weaknesses of the stakeholder theory about the social responsibilities of business which lacks prohibitions against fraud and deception. This is a glaring deficiency of standard versions of the stakeholder theory, but it is easily remedied by adding explicit prohibitions against fraud and deception. In addition, recent events highlight the stakeholder theory's very naive and unrealistic hopes and expectations for business executives as moral arbiters and agents of social improvement.
2. Recent events do not constitute an objection to the shareholder theory about the social responsibilities of business. However,

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these events make evident the implausibility of strong versions of the invisible hand theory. Self-interested actions by executives do not necessarily promote the common good. There is much more need for ethical constraints on the actions of economic actors than is conceded by many defenders of the shareholder theory and free-market capitalism.

3. Schemes of payment and reward often create perverse incentives for individuals to engage in unethical conduct. Work in management theory and business ethics needs to do more to address these incentives and consider possible remedies.
4. Both the shareholder theory and the stakeholder theory need to add a constraint that prohibits executives from pressuring, enticing, or permitting professionals who work for corporations to act contrary to the moral codes of their professions or engage in fraud or deception.

1. *The stakeholder theory*

The stakeholder theory says that corporations should be run for the benefit of all "stakeholders," not just the shareholders. R. Edward Freeman is the most prominent defender of the stakeholder theory. In his paper "A Stakeholder Theory of the Modern Corporation," Freeman writes:

> Corporations shall be managed in the interests of its stakeholders, defined as employees, financiers, customers, employees, and communities.[1]

In an earlier paper written together with William Evan, Freeman states his theory as follows:

P1: The corporation should be managed for the benefit of its stakeholders: its customers, suppliers, owners, employees, and local communities. The rights of these groups must be ensured, and further, the groups must participate in some sense in decisions that substantially affect their welfare.

P2: Management bears a fiduciary relationship to stakeholders and to the corporation as an abstract entity. It must act in the interests of the shareholders as their agent, and it must act in the interests of the corporation to ensure the survival of the firm, safeguarding the long-term stakes of each group.[2]

Freeman's version of the stakeholder theory and other standard versions of the theory do not include prohibitions against fraud and deception.[3] The executives at Enron and WorldCom might conceivably have "rationalized" their actions by appeal to the stakeholder theory. (The rise in stock prices brought about by creative accounting did, for a time, seem to promote the interests of many stakeholders, including employees who owned stock.) I do not claim that the stakeholder theory actually justifies what they did. Rather, my point is that it is not *sufficiently obvious* that the stakeholder theory prohibits the kind of fraud and deception in question. People who try to follow the stakeholder theory could easily misapply it in this way. An op-ed piece by Holman Jenkins, Jr. in the *Wall Street Journal* provides some indirect evidence for this.[4] Jenkins thinks that the harm and the extent of wrongdoing in recent accounting cases have been greatly exaggerated. He says that it is a "myth" that Bernie Ebbers [WorldCom Chief] "destroyed thousands of lives." In response to this charge, Jenkins writes:

> Bernie Ebbers created thousands of jobs and whoever cooked the books was trying to keep the company afloat and save those jobs amid a global telecom meltdown. WorldCom's stock price had already fallen to less than a buck before the admitted fraud began.

Jenkins makes no mention of the stakeholder theory and does not attempt to apply the stakeholder theory to this case. However, he apparently believes that dishonest accounting could be in the interests of some of the stakeholders of a struggling company. Were he or anyone of this opinion attempting to apply the stakeholder theory to this case, he would have to seriously entertain the possibility that fraudulent

accounting is permissible. Jenkins had no self-interested reasons for wanting WorldCom to "cook its books." Any manager with self-interested reasons to cook the books would be even more likely to rationalize fraud on the grounds that it benefits employees and shareholders.

The stakeholder theory needs "side constraints" on promoting the interests of stakeholders in just the same way that the shareholder theory needs constraints on promoting the interests of shareholders. The stakeholder theory would be more plausible if we say that executives should make it a policy not to lie, deceive, or commit fraud, even when they judge that to do so would, on balance, benefit stakeholders. It is a good policy for businesspeople to regard certain acts as out of bounds and not even consider whether they would promote the interests of stakeholders. This makes the theory much clearer and simpler to apply as an action guide and helps to guard against rationalizing wrong conduct. With side constraints that strictly prohibit deception and fraud, the stakeholder theory would clearly and unequivocally prohibit the types of misconduct at issue. Executives couldn't easily rationalize such conduct by reference to this sort of standard; clear-thinking executives couldn't do so at all.

The stakeholder theory makes very naive and unrealistic assumptions about the abilities and moral capacities of business executives. Recent events strongly argue against the grandiose role that the stakeholder theory assigns to corporate executives. Corporate executives need to be given less power and discretion, not more. In the case of high-ranking business executives, discretion to do good is also discretion to do bad. The acceptance of a code of ethics that gives them more power and discretion would lead to more self-dealing and self-aggrandizement by management. Corporate executives cannot be relied upon to accurately discern and impartially promote the interests of all stakeholders and be the agents of all manner of social improvement. We must be content with more modest expectations such as asking executives to pursue normal business goals while refraining from fraud, deception, and plunder. In several very revealing passages, R. Edward Freeman unwittingly lends support to this criticism. He notes that, because of the many competing claims of different stakeholder groups, managers need Solomonic wisdom to follow the stakeholder theory and appropriately "balance" the competing claims and interests in question – "the task of management in today's corporation is akin to that of King Solomon."[5] Since few business executives possess Solomonic wisdom, any theory that requires that they possess such wisdom is implausible as a code of conduct for them.

2. *The shareholder theory and the invisible hand*

The most well-known version of the shareholder theory is Milton Friedman's. Friedman formulates his version of the shareholder theory in the following passage in *Capitalism and Freedom*:

> In such an economy ["a free economy"], there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.[6]

In his essay "Social Responsibility of Business" Friedman gives a somewhat different statement of the theory:

> 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 will generally be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and in ethical custom.[7]

The recent events in question do not constitute an objection to the traditional shareholder theory about the social responsibilities of business. The misconduct of the executives at Enron and WorldCom was not mandated or permitted by the shareholder theory. The shareholder theory *clearly* prohibits the actions of these executives. The executives acted in their own

self-interest to the detriment of shareholders – they clearly did not act in the best interests of shareholders. However, since the rise in stock prices brought about by creative accounting did, for a time, seem to promote the interests of shareholders, executives could conceivably have *believed* that the sort of fraud and deception they practiced promoted the interests of shareholders. Nonetheless, the executives could not easily rationalize or justify their conduct by reference to the shareholder theory, because the shareholder theory includes explicit prohibitions against fraud and deception. A clear-thinking executive couldn't possibly believe that the shareholder theory permits fraud and deception. Milton Friedman holds that business executives must promote the interests of shareholders while refraining from fraud and deception and engaging in open and free competition. The prohibitions against fraud and deception are "side constraints" on promoting the interests of shareholders – executives are never permitted to advance the interests of shareholders by means of fraud or deception.

The foregoing not withstanding, the Enron and WorldCom cases highlight some serious problems with the rosy view of *laissez faire* capitalism endorsed by many defenders of capitalism and the shareholder theory. These defenders argue that one of the greatest virtues of capitalism is that, through the workings of the invisible hand, it makes the motives of greed and economic self-interest work to promote the general welfare. However, the self-interested actions of the Enron executives and the accountants at Arthur Andersen led them to do things that were extremely harmful to the public interest. There is far more need for ethical constraints on the actions of economic actors than is sometimes conceded.

Milton Friedman does not hold the crude version of the invisible hand theory in question. Friedman thinks that self-interested actions tend to promote the general welfare only when appropriate laws are in place.[8] However, even with the needed qualifications about refraining from fraud and deception and the existence of an appropriate legal code, the view that self-interested actions by businesspeople in capitalist societies strongly tend to promote the general welfare is mistaken in at least one important respect. Adam Smith's model of the invisible hand presupposes that businesses are managed by their owners. In Smith's model, the business person who promotes the general welfare by means of self-interested actions owns the business he manages and does not act as an agent for others. Modern capitalism involves a sharp divorce between the ownership and management of business. The diffusion of ownership in the modern corporation makes it very difficult for shareholders to exercise effective control over their investments. This gives considerable scope for high-ranking executives to enrich themselves at the expense of shareholders and everyone else. I have in mind such things as excessive pay and perks, sky boxes, golden parachutes, and bloated executive bureaucracies.[9] Such actions are clearly harmful to society as a whole. It is at least arguable that the common good is generally promoted when corporations are managed so as to maximize profits or returns to shareholders (within certain constraints).[10] However, inasmuch as managers and owners have very divergent interests, self-interested actions by executives have no such tendency to promote the general welfare. Self-interested conduct by executives can lead to self-dealing and plunder of the sort so graphically illustrated in the recent scandals.

3. *Perverse incentives*

Terms of employment and compensation schemes can create incentives for unethical conduct. Some stock option plans for executives reward executives who resort to deception to temporarily drive up the price of their company's stock. (The value of a stock option increases when the price of the stock rises. If I know that the price of a stock will rise only temporarily, I know that it will be in my interests to sell the option. I also know that anyone who purchases the option will loose money.) Requirements for managers and salespeople to meet monthly and yearly goals often tempt business people to fudge their accounting standards. Here is a concrete example of the kind of thing I have in mind. Some sales-

people need to meet monthly sales quotas. Failing to meet these quotas can cause one to be fired even if one's yearly sales are satisfactory. Under such a rule, a salesperson who "makes her numbers" before the end of the month will be likely to count sales that she makes near the end of the month towards the next month's quota to minimize the chance of being short the next month. Salespeople often have the freedom to fudge these sorts of things. A sale can be counted either at the time when it is contracted or at the time when payment arrives. Perverse incentives cannot be completely eliminated. Poorly performing employees will always have reasons to deceive their superiors about their own shortcomings. Theft and plunder will always be advantageous to some people who are able to steal from businesses without getting caught. However, this issue deserves much more attention from management theorists and business ethicists. Rules, decision procedures, and schemes for reward and compensation all need to be scrutinized for the incentives they create.

4. *Respecting the moral duties of subordinates and professionals*

The deception involved in the cases in question succeeded only because internal and external accountants at Enron and Worldcom gave dishonest reports and violated the ethical norms of their profession. The executives at Enron and WorldCom pressured and enticed their accountants to do this. It is not enough that executives themselves refrain from fraud and deception, they must not encourage or permit fraud or deception by subordinates or those who work for the corporation. Both the shareholder theory and the stakeholder theory need to add an explicit requirement to this effect. In addition, theories about the social responsibilities of business need to add an explicit requirement that executives not require, pressure, or permit professionals who work for the company to violate their own professional obligations, e.g., their obligations as accountants, lawyers, or engineers. By "respecting the obligations of professionals" I mean respecting the obligations set forth in formal codes of ethics for professions, e.g., codes of ethics for accountants, lawyers, and engineers.

One general moral that emerges from this paper is that the design of business and economic institutions matters greatly from the moral point of view. The optimal macro design for the economy includes legal and professional[11] regulatory mechanisms to enforce prohibitions against fraud and deception. The optimal micro designs for businesses include well-designed compensation schemes which discourage deception, fraud, and self-dealing. Stock options were a well-intended mechanism designed to more closely align the interests of managers and shareholders. Stock options failed disastrously in this regard because they created incentives for managers to enrich themselves through fraud. This example shows that caution is in order when trying to change the incentives of business people. Such changes often produce unintended consequences.

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Notes

[1] In Tom Beauchamp and Norman Bowie, eds., *Ethical Theory and Business*, 5th edition (Upper Saddle River, NJ: Prentice Hall, 1997), p. 75.

[2] "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism," in *Ethical Theory and Business*, 4th edition, Tom Beauchamp and Norman Bowie (Englewood Cliffs, NJ: Prentice Hall, 1993), p. 82.

[3] Goodpaster's paper "Business Ethics and Stakeholder Analysis," *Business Ethics Quarterly* **1** (1991): 53–72 is arguably an exception to this. Goodpaster's theory includes prohibitions against lying and cheating and he calls his theory a version of the "stakeholder theory." However, this label is arguably misleading because his theory is nearly equivalent to the theory we get if we add rule a rule against harming others to Friedman's *shareholder* theory.

According to Goodpaster, businesses have fiduciary obligations only to shareholders, but they also have non-fiduciary moral obligations to those affected

by their actions (stakeholders). The non-fiduciary obligations to stakeholders include "extra-legal obligations not to injure, lie to or cheat these stakeholders *quite apart from* whether it is in the stockholders' interests." On this view, the only "positive duty" of business is to act in the best interests of shareholders. But this duty is constrained by negative duties (not to cheat, injure, or lie) to all stakeholders. (Almost anyone who is injured, cheated or lied to by a business is sufficiently affected by the business to count as a stakeholder.) Therefore, the principle, "Promote the interests of shareholders, while refraining from injuring, cheating or lying to stakeholders" is equivalent to the principle, "Promote the interests of shareholders, while refraining from injuring, cheating or lying to *anyone*." This view is very similar to Friedman's theory of corporate social responsibility. Friedman and Goodpaster agree that the only positive obligation of business is to serve the interests of shareholders (which will generally be to make as much money as possible). They also agree that this duty is constrained by certain prohibitions or negative duties. In *Capitalism and Freedom*, Friedman says that the duty to maximize profits is constrained by the duty to refrain from fraud and deception and engage in open and free competition. Friedman's prohibition against "fraud" is roughly equivalent to Goodpaster's prohibition against "cheating." Similarly, Friedman's rule against deception is roughly the same as Goodpaster's rule against lying. Goodpaster says businesses have a duty to obey the law. Friedman's statement of his theory in *Capitalism* and *Freedom* says nothing about the duty to obey the law. However, in "Social Responsibilities of Business," Friedman holds that the responsibility of executives to serve the interests of shareholders is constrained by the duty to obey the law. The main difference between Friedman's theory and Goodpaster's theory is that Goodpaster's side constraints on profit maximizing include a prohibition against injuring others. For more on Goodpaster, see my paper, "Does the Stakeholder Theory Constitute a New Kind of Theory of Social Responsibility?," *Business Ethics Quarterly* **3** (1993): 171–176.

[4] July 17, 2002.

[5] R. Edward Freeman, "A Stakeholder Theory of the Modern Corporation," in *Ethical Theory and Business*, 5th edition Tom Beauchamp and Norman Bowie (Englewood Cliffs, NJ: Prentice Hall, 1997), p.71; also see William Evan and R. Edward Freeman, "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism," in *Ethical Theory and Business*, 4th edition Tom Beauchamp and Norman Bowie (Englewood Cliffs, NJ: Prentice Hall, 1993), p. 81.

[6] Chicago: University of Chicago Press, 1963, p. 133.

[7] *New York Times Magazine*, September 13, 1970, reprinted in *An Economist's Protest* (Thomas Horton, 1972), p. 178.

[8] Immediately after the passage in *Capitalism and Freedom* in which he states his theory about the social responsibilities of business, Friedman writes:

> Similarly, the "social responsibility" of labor leaders is to serve the interests of the members of the unions. It is the responsibility of the rest of us to establish a framework of law such that an individual pursuing his own interest is to quote Adam Smith again, "led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest, he frequently promotes that of society more effectively than when he intends to promote it. . . ." (p. 133).

I take it that what he regards as the appropriate legal framework includes laws against deception and fraud.

[9] For many actual examples, see Adolf Berle and Gardner Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1944). Also see Henry Hansman, *The Ownership of Enterprise* (Cambridge, MA: Harvard University Press, 1996).

[10] For my purposes in this paper, I want to leave open the question of whether actions by executives that promote the interests of shareholders (and adhere to the constraints on profit maximization) also tend to promote the general welfare.

[11] This includes codes of ethics for professions.

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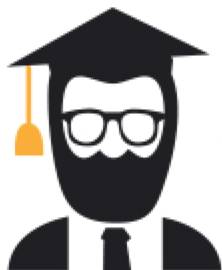

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