Business ethics is a subset of ethics: no special set of ethical principles applies only to the world of business. Immoral acts are immoral, whether or not a businessperson has committed them. In the last few years, countless business wrongs, such as insider trading, the Beech-Nut adulterated apple juice scandal, the Bhopal disaster, the Dalkon Shield tragedy, and the savings and loan industry collapse have been reported almost daily.

Ethics can be defined broadly as the study of what is right or good for human beings. It attempts to determine what people ought to do, or what goals they should pursue. Business ethics, as a branch of applied ethics, is the study and determination of what is right and good in business settings. Business ethics seeks to understand the moral issues that arise from business practices, institutions, and decision making and their relationship to generalized human values. Unlike legal analyses, analyses of ethics have no central authority, such as courts or legislatures, upon which to rely; nor do they follow clear-cut, universal standards. Nonetheless, despite these inherent limitations, it still may be possible to make meaningful ethical judgments. To improve ethical decision making, it is important to understand how others have approached the task.

Some examples of the many business ethics questions may help to clarify the definition of business ethics. In the employment relationship, countless ethical issues arise regarding the safety and compensation of workers, their civil rights (such as equal treatment, privacy, and freedom from sexual harassment), and the legitimacy of whistleblowing. In the relationship between business and its customers, ethical issues permeate marketing techniques, product safety, and consumer protection. The relationship between business and its owners bristles with ethical questions involving corporate governance, shareholder voting, and management’s duties to the shareholders. The relationship among competing businesses involves numerous ethical matters, including fair competition and the effects of collusion. The interaction between business and society at large presents additional ethical dimensions: pollution of the physical environment, commitment to the community’s economic and social infrastructure, and depletion of

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**Learning Objectives**

After reading this chapter you should be able to:

1. Describe the difference between law and ethics.
2. Compare the various ethical theories.
3. Describe cost-benefit analysis and explain when it should be used and when it should be avoided.
4. Explain Kohlberg’s stages of moral development.
5. Explain the ethical responsibilities of business.
natural resources. Not only do all of these issues recur at the international level, but additional ones present themselves, such as bribery of foreign officials, exploitation of less-developed countries, and conflicts among differing cultures and value systems. (See “The Aftermath of Bhopal.”)

In resolving the ethical issues raised by business conduct, it is helpful to use a seeing-knowing-doing model. First, the decision maker should see (identify) the ethical issues involved in the proposed conduct, including the ethical implications of the various available options. Second, the decision maker should know (resolve) what to do by choosing the best option. Finally, the decision maker should do (implement) the chosen option by developing implementing strategies.

This chapter first surveys the most prominent ethical theories (the knowing part of the decision, on which the great majority of philosophers and ethicists have focused). The chapter then examines ethical standards in business and the ethical responsibilities of business. It concludes with five ethical business cases, which give the student the opportunity to apply the seeing-knowing-doing model. The student (1) identifies the ethical issues presented in these cases; (2) resolves these issues by using one of the ethical theories described in the chapter, some other ethical theory, or a combination of the theories; and (3) develops strategies for implementing the ethical resolution.

LAW VERSUS ETHICS

As discussed in Chapter 1, moral concepts strongly affect the law, but law and morality are not the same. Although it is tempting to say that “if it’s legal, it’s moral,” such a proposition is generally too simplistic. For example, it would seem gravely immoral to stand by silently while a blind man walks off a cliff if one could prevent the fall by shouting a warning, even though one would not be legally obligated to do so. Similarly, moral questions arise concerning “legal” business practices, such as failing to fulfill a promise that is not legally binding; exporting products banned in the United States to third world countries where they are not prohibited; or slaughtering baby seals for fur coats. The mere fact that these practices are legal does not prevent them from being challenged on moral grounds.

Just as it is possible for legal acts to be immoral, it is equally possible for illegal acts to seem morally preferable to following the law. For example, it is the moral conviction of the great majority of people that those who sheltered Jews in violation of Nazi edicts during World War II and those who committed acts of civil disobedience in the 1950s and 1960s to challenge segregation laws in the United States were acting properly and that the laws themselves were immoral.

ETHICAL THEORIES

Philosophers have sought for centuries to develop dependable and universal methods for making ethical judgments. In earlier times, some thinkers analogized the discovery of ethical principles with the derivation of mathematical proofs. They asserted that people could discover fundamental ethical rules by applying careful reasoning a priori. (A priori reasoning is based on theory rather than experimentation and deductively draws conclusions from cause to effect and from generalizations to particular instances.) In more recent times, many philosophers have concluded that although careful reasoning and deep thought assist substantially in moral reasoning, experience reveals that the complexities of the world defeat most attempts to fashion precise, a priori guidelines. Nevertheless, a review of the most significant ethical theories is useful in the analysis of issues of business ethics.

Ethical Fundamentalism

Under ethical fundamentalism, or absolutism, individuals look to a central authority or set of rules to guide them in ethical decision making. Some look to the Bible; others look to the Koran or the writings of Karl Marx or to any number of living or deceased prophets. The essential characteristic of this approach is a reliance upon a central repository of wisdom. In some cases, such reliance is total. In others, followers of a religion or a spiritual leader may believe that all members of the group are obligated to assess moral dilemmas independently, according to each person’s understanding of the dictates of the fundamental principles.

Ethical Relativism

Ethical relativism is a doctrine asserting that actions must be judged by what individuals feel is right or wrong for themselves. It holds that when any two individuals or cultures differ regarding the morality of a particular issue or action, they are both correct because morality is relative. However, though ethical relativism promotes open-mindedness and tolerance, it has limitations. If each person’s actions are always correct for that person, then
MANAGERIAL insight

The Aftermath of Bhopal

When corporations operate internationally, they confront ethical issues related to political, social, and cultural differences among countries. Take, for example, the case of Union Carbide.

In 1984, the multinational chemical company had interests in thirty-five countries and, at least in the United States, boasted one of the best safety records among major manufacturers of chemical products. That was before the tragedy at Bhopal, India.

Union Carbide owned nearly 51 percent of Union Carbide India Limited (UCIL), a publicly traded corporation in India that ranked at the time as the country’s twenty-first largest company. At the urging of the Indian government, UCIL went into the pesticide business in the 1960s, a time when India was attempting to modernize its agricultural base and produce more food. Also, at the government’s urging, UCIL located in India’s Bhopal region, a densely populated but extremely impoverished area. In addition, the subsidiary installed a manually operated safety system at the Bhopal plant, rather than an automatic one. (The manual system provided more jobs, a goal of the Indian government.) By the early 1980s, the UCIL plant was losing money. Squeezed by a drop in the demand for pesticides, the plant was operating at only 40 percent of its capacity. It also had taken steps to cut costs. One was to manufacture the commonly used pesticide, Sevin, in bulk quantities, from start to finish, at the plant. This required UCIL not only to make large quantities of methyl isocyanate (MIC) but also to store the highly dangerous, extremely volatile chemical on-site. The company also cut its workforce, which impaired plant maintenance.

Not long before midnight on Sunday, December 2, 1984, a Bhopal plant engineer, Suman Dey, noticed that the pressure and temperature gauges on tank E610, which held some forty-five tons of MIC, had climbed to the boiling point. The normally refrigerated tank held the chemical, deadly in its gaseous state, in a cool, liquid form. But now the tank had lost its refrigeration. Employees had reason to believe that the gauges did not work properly, yet they searched for a leak anyway. Then, shortly after midnight, Dey heard what sounded like an explosion in the tank. Within seconds, a toxic cloud of MIC escaped. The silent, deadly fog enveloped the area close to the plant and then rolled down toward Bhopal’s railroad station and its main city.

The UCIL plant had been built in what was, at the time, an open area, but by the time of the accident, a large, densely populated shantytown had grown up around it. Squatters had moved in as close as the plant’s gate. In the early morning hours of December 3, many of these squatters died where they fell, their lungs seared by MIC. Others were killed in the stampede to escape the deadly gas. As the cloud drifted over Bhopal, more victims fell in its wake. Of those who survived, many were permanently blinded or otherwise disabled. In all, approximately 200,000 people were injured. Today, estimates of the death toll range from more than 2,000 victims to as many as 30,000 victims.

When Union Carbide’s chairperson, Warren M. Anderson, arrived in Bhopal shortly after the disaster, he was arrested and charged with homicide. In the United States, the company faced a takeover bid from GAF Corporation, which it avoided only by selling off its consumer products division, maker of Prestone antifreeze, Eveready batteries, and Glad Bags.

In 1989, the Indian Supreme Court ordered Union Carbide, now only a shadow of its former self, to pay $470 million to compensate Bhopal victims. Criminal charges against the company and its officials, though, were dropped.

For a multinational corporation like Union Carbide, the lesson of Bhopal is simple: Be careful. Yet how careful should a company be? Should multinational corporations maintain in their overseas plants safety standards the same as those they maintain in their U.S. operations? Or should the governments of host countries determine required safety standards?

Whatever the answers, any corporation doing business in another country should consider the following: To operate successfully in a foreign land requires a deep understanding of the political, social, and cultural differences among countries. Often, such an enterprise also demands a keen sense of advanced technology’s impact on underdeveloped nations.

his behavior is, by definition, moral and, therefore, exempt from criticism. Once a person concludes that criticizing or punishing behavior in some cases is appropriate, he abandons ethical relativism and faces the task of developing a broader ethical methodology.

Although bearing a surface resemblance to ethical relativism, situational ethics actually differs substantially. Situational ethics holds that developing precise guidelines for effectively navigating ethical dilemmas is difficult because real-life decision making is so complex. To judge the morality of someone’s behavior, the person judging must actually put herself in the other person’s shoes to understand what motivated the other to choose a particular course of action. Situational ethics, however, does not cede the ultimate judgment of the propriety of an action to the actor; rather, it insists that, prior
Utilitarianism

Utilitarianism is a doctrine that assesses good and evil in terms of the consequences of actions. Those actions that produce the greatest net pleasure compared with net pain are better in a moral sense than those that produce less net pleasure. As Jeremy Bentham (http://www.utm.edu/research/iep/b/bentham.htm), one of the most influential proponents of utilitarianism, proclaimed, a good or moral act is one that results in “the greatest happiness for the greatest number.”

The two major forms of utilitarianism are act utilitarianism and rule utilitarianism. Act utilitarianism assesses each separate act according to whether it maximizes pleasure over pain. For example, if telling a lie in a particular situation produces more overall pleasure than pain, then an act utilitarian would support lying as the moral thing to do. Rule utilitarians, disturbed by the unpredictability of act utilitarianism and its potential for abuse, follow a different approach. Rule utilitarianism holds that general rules must be established and followed even though, in some instances, following rules may produce less overall pleasure than not following them. It applies utilitarian principles in developing rules; thus, it supports rules that on balance produce the greatest satisfaction. Determining whether telling a lie in a given instance would produce greater pleasure than telling the truth is less important to the rule utilitarian than deciding whether a general practice of lying would maximize society's pleasure. If lying would not maximize pleasure generally, then one should follow a rule of not lying even though on occasion telling a lie would produce greater pleasure than would telling the truth.

Utilitarian notions underlie cost-benefit analysis, an analytical tool used by many business and government managers today. Cost-benefit analysis first quantifies in monetary terms and then compares the direct and indirect costs and benefits of program alternatives for meeting a specified objective. Cost-benefit analysis seeks the greatest economic efficiency, according to the underlying notion that, given two potential acts, the act achieving the greatest output at the least cost promotes the greatest marginal happiness over the less-efficient act, other things being equal.

The chief criticism of utilitarianism is that in some important instances it ignores justice. A number of situations would maximize the pleasure of the majority at great social cost to a minority. Another major criticism of utilitarianism is that measuring pleasure and pain in the fashion its supporters advocate is extremely difficult, if not impossible.

Deontology

Deontological theories (from the Greek word deon, meaning duty or obligation) address the practical problems of utilitarianism by holding that certain underlying principles are right or wrong regardless of any pleasure or pain calculations. Believing that actions cannot be measured simply by their results but must be judged by means and motives as well, deontologists judge the morality of acts not so much by their consequences but by the motives that lead to them. A person not only must achieve just results but also must employ the proper means.

The best-known deontological theory was proffered by the eighteenth-century philosopher Immanuel Kant (http://www.utm.edu/research/iep/k/kantmeta.htm). Under Kant's categorical imperative, for an action to be moral it (1) must potentially be a universal law that could be applied consistently and (2) must respect the autonomy and rationality of all human beings and not treat them as an expedient. That is, one should not do anything that he or she would not have everyone do in a similar situation. For example, you should not lie to colleagues unless you support the right of all colleagues to lie to one another. Similarly, you should not cheat others unless you advocate everyone's right to cheat. We apply Kantian reasoning when we challenge someone's behavior by asking: What if everybody acted that way?

Under Kant's approach, it would be improper to assert a principle to which one claimed personal exception, such as insisting that it was acceptable for you to cheat but not for anyone else to do so. This principle could not be universalized because everyone would then insist on similar rules from which only they were exempt.

Kant's philosophy also rejects notions of the end justifying the means. To Kant, every person is an end in himself or herself. Each person deserves respect simply because of his or her humanity. Thus, any sacrifice of a person for the greater good of society would be unacceptable to Kant.

In many respects, Kant's categorical imperative is a variation of the Golden Rule; and, like the Golden Rule, the categorical imperative appeals to the individual's self-centeredness.

As does every theory, Kantian ethics has its critics. Just as deontologists criticize utilitarians for excessive pragmatism and flexible moral guidelines, utilitarians and others criticize deontologists for rigidity and excessive formalism. For example, if one inflexibly adopts as a rule to tell the truth, one ignores situations in which lying might well be justified. A person hiding a terrified wife from her angry, abusive husband would seem to be acting morally by falsely denying that the wife is at the person's
house. Yet a deontologist, feeling bound to tell the truth, might ignore the consequences of truthfulness, tell the husband where his wife is, and create the possibility of a terrible tragedy. Another criticism of deontological theories is that the proper course may be difficult to determine when values or assumptions conflict.

**Social Ethics Theories**

Social ethics theories assert that special obligations arise from the social nature of human beings. Such theories focus not only on each person’s obligations to other members of society but also on the individual’s rights and obligations within the society. For example, social egalitarians believe that society should provide each person with equal amounts of goods and services regardless of the contribution each makes to increase society’s wealth.

Two other ethics theories have received widespread attention in recent years. One is the theory of distributive justice proposed by Harvard philosopher John Rawls (http://www.geocities.com/Athens/Parthenon/1643/rawls.html), which seeks to analyze the type of society that people in a “natural state” would establish if they could not determine in advance whether they would be talented, rich, healthy, or ambitious, relative to other members of society. According to distributive justice, the society contemplated through this “veil of ignorance” is the one that should be developed because it considers the needs and rights of all its members. Rawls did not argue that such a society would be strictly egalitarian, and that it would unfairly penalize those who turned out to be the most talented and ambitious. Instead, Rawls suggested that such a society would stress equality of opportunity, not of results. On the other hand, Rawls stressed that society would pay heed to the least advantaged to ensure that they did not suffer unduly and that they enjoyed society’s benefits. To Rawls, society must be premised on justice. Everyone is entitled to his or her fair share in society, a fairness all must work to guarantee.

In contrast to Rawls, another Harvard philosopher, Robert Nozick (http://www.fas.harvard.edu/~phildept/frames/html/body_faculty_pages_7.html), stressed liberty, not justice, as the most important obligation that society owes its members. Libertarians stress market outcomes as the basis for distributing society’s rewards. Only to the extent that one meets market demands does one deserve society’s benefits. Libertarians oppose social interference in the lives of those who do not violate the rules of the marketplace, that is, in the lives of those who do not cheat others and who disclose honestly the nature of their transactions with others. The fact that some end up with fortunes while others accumulate little simply proves that some can play in the market effectively while others cannot. To libertarians, this is not unjust. What is unjust to them is any attempt by society to take wealth earned by citizens and distribute it to those who did not earn it.

These theories and others (e.g., Marxism) judge society in moral terms by its organization and by the way in which it distributes goods and services. They demonstrate the difficulty of ethical decision making in the context of a social organization: behavior that is consistently ethical from individual to individual may not necessarily produce a just society.

**Other Theories**

The preceding theories do not exhaust the possible approaches to evaluating ethical behavior; several other theories also deserve mention. Intuitionism holds that a rational person possesses inherent powers to assess the correctness of actions. Though an individual may refine and strengthen these powers, they are just as basic to humanity as our instincts for survival and self-defense. Just as some people are better artists or musicians, some people have more insight into ethical behavior than others. Consistent with intuitionism is the good person philosophy, which declares that if individuals wish to act morally, they should seek out and emulate those who always seem to know the right choice in any given situation and who always seem to do the right thing. One variation of these ethical approaches is the Television Test,” which directs us to imagine that every ethical decision we make is being broadcast on nationwide television. An appropriate decision is one we would be comfortable broadcasting on national television for all to witness.

**Ethical Standards in Business**

In this section we will explore the application of the theories of ethical behavior to the world of business.

**Choosing an Ethical System**

In their efforts to resolve the moral dilemmas facing humankind, philosophers and other thinkers have struggled for years to refine the various systems previously discussed. All of the systems are limited, however, in terms of applicability and tend to produce unacceptable prescriptions for action in some circumstances. But to say that each system has limits is not to say it is useless. On the contrary, a number of these systems provide insight into ethical decision making and help us formulate issues and resolve moral dilemmas. Furthermore,
concluding that moral standards are difficult to articulate and that moral boundaries are imprecise is not the same as concluding that moral standards are unnecessary or nonexistent.

Research by the noted psychologist Lawrence Kohlberg provides some insight into ethical decision making and lends credibility to the notion that moral growth, like physical growth, is part of the human condition. Kohlberg observed that people progress through sequential stages of moral development (http://moon.pepperdine.edu/gsep/class/ethics/kohlberg/) according to two major variables: age and reasoning. During the first level—the preconventional level—a child’s conduct is a reaction to the fear of punishment and, later, to the pleasure of reward. Although people who operate at this level may behave in a moral manner, they do so without understanding why their behavior is moral. The rules are imposed upon them. During adolescence—Kohlberg’s conventional level—people conform their behavior to meet the expectations of groups, such as family, peers, and eventually society. The motivation for conformity is loyalty, affection, and trust. Most adults operate at this level. According to Kohlberg, some reach the third level—the postconventional level—where they accept and conform to moral principles because they understand why the principles are right and binding. At this level, moral principles are voluntarily internalized, not externally imposed. Moreover, individuals at this stage develop their own universal ethical principles and may even question the laws and values that society and others have adopted (see Figure 2-1).

Kohlberg believed that not all people reach the third, or even the second, stage. He therefore argued that essential to the study of ethics was the exploration of ways to help people achieve the advanced stage of postconventional thought. Other psychologists assert that individuals do not pass sequentially from stage to stage but rather function in all three stages simultaneously.

Whatever the source of our ethical approach, we cannot avoid facing moral dilemmas that challenge us to recognize and to do the right thing. Moreover, for those who plan business careers, such dilemmas necessarily will have implications for many others—employees, shareholders, suppliers, customers, and society at large.

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<td>Punishment/Reward</td>
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<td>Group</td>
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<td>Postconventional (Adulthood)</td>
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Corporations as Moral Agents

Because corporations are not persons but artificial entities created by the state, whether they can or should be held morally accountable is difficult to determine. Though, clearly, individuals within corporations can be held morally responsible, the corporate entity presents unique problems.

Commentators are divided on the issue. Some insist that only people can engage in behavior that can be judged in moral terms. Opponents of this view concede that corporations are not persons in any literal sense but insist that the attributes of responsibility inherent in corporations are sufficient to justify judging corporate behavior from a moral perspective.

Ethical Responsibilities of Business

Many people assert that the only responsibility of business is to maximize profit and that this obligation overrides any ethical or social responsibility. Although our economic system of modified capitalism is based on the pursuit of self-interest, it also contains components to check this motivation of greed. Our system has always recognized the need for some form of regulation, whether it be by the “invisible hand” of competition, the self-regulation of business, or government regulation.

Regulation of Business

As explained and justified by Adam Smith in *The Wealth of Nations* (1776), the capitalistic system is composed of six “institutions”: economic motivation, private productive property, free enterprise, free markets, competition, and limited government. As long as all these constituent institutions continue to exist and operate in balance, the factors of production—land, capital, and labor—combine to produce an efficient allocation of resources for individual consumers and for the economy as a whole. To achieve this outcome, however, Smith’s model requires that a number of conditions be satisfied: “standardized products, numerous firms in markets, each firm with a small share and unable by its actions alone to
exert significant influence over price, no barriers to entry, and output carried to the point where each seller’s marginal cost equals the going market price.”  E. Singer, Antitrust Economics and Legal Analysis.

History has demonstrated that the actual operation of the economy has satisfied almost none of these assumptions. More specifically, the actual competitive process falls considerably short of the assumptions of the classic economic model of perfect competition:

Competitive industries are never perfectly competitive in this sense. Many of the resources they employ cannot be shifted to other employments without substantial cost and delay. The allocation of those resources, as between industries or as to relative proportions within a single industry, is unlikely to have been made in a way that affords the best possible expenditure of economic effort. Information is incomplete, motivation confused, and decision therefore ill informed and often unwise. Variations in efficiency are not directly reflected in variations of profit. Success is derived in large part from competitive selling efforts, which in the aggregate may be wasteful, and from differentiation of products, which may be undertaken partly by methods designed to impair the opportunity of the buyer to compare quality and price.

C. Edwards, Maintaining Competition

In addition to capitalism’s failure to allocate resources efficiently, it cannot be relied on to achieve all of the social and public policy objectives a pluralistic democracy requires. For example, the free enterprise model simply does not address equitable distribution of wealth, national defense, conservation of natural resources, full employment, stability in economic cycles, protection against economic dislocations, health and safety, social security, and other important social and economic goals. Increased regulation of business has occurred not only to preserve the competitive process in our economic system but also to achieve social goals extrinsic to the efficient allocation of resources, the “invisible hand” and self-regulation by business having failed to bring about these desired results. Such intervention attempts (1) to regulate both “legal” monopolies, such as those conferred by laws through copyrights, patents, and trade symbols, and “natural” monopolies, such as utilities, transportation, and communications; (2) to preserve competition by correcting imperfections in the market system; (3) to protect specific groups, especially labor and agriculture, from marketplace failures; and (4) to promote other social goals. Successful government regulation involves a delicate balance between regulations that attempt to preserve competition and those that attempt to advance other social objectives. The latter should not undermine the basic competitive processes that provide an efficient allocation of economic resources.

Corporate Governance

In addition to the broad demands of maintaining a competitive and fair marketplace, another factor demanding the ethical and social responsibility of business is the sheer size and power of individual corporations. The five thousand largest U.S. firms currently produce more than half of the nation’s gross national product.

In a classic study published in 1932, Adolph Berle and Gardner Means concluded that great amounts of economic power had been concentrated in a relatively few large corporations, that the ownership of these corporations had become widely dispersed, and that the shareholders had become far removed from active participation in management. Since their original study, these trends have continued steadily. Thus, vast amounts of wealth and power are controlled by a small number of corporations, which are in turn controlled by a small group of corporate officers.

These developments raise a large number of social, policy, and ethical issues about the governance of large, publicly owned corporations. Many observers insist that companies playing such an important economic role should have a responsibility to undertake projects that benefit society in ways that go beyond mere financial efficiency in producing goods and services. In some instances, the idea of corporate obligations comes from industrialists themselves.

Arguments Against Social Responsibility

A number of arguments oppose business involvement in socially responsible activities: profitability, unfairness, accountability, and expertise.

Profitability As Milton Friedman (http://www-hoovers.stanford.edu/BIOS/friedman.html) and others have argued, businesses are artificial entities established to permit people to engage in profit-making, not social, activities. Without profits, they assert, there is little reason for a corporation to exist and no real way to measure the effectiveness of corporate activities. Businesses are not organized to engage in social activities; they are structured to produce goods and services for which they receive money. Their social obligation is to return as much of this money as possible to their direct stakeholders. In a free market with significant competition, the selfish pursuits of corporations will lead to maximizing output, minimizing costs, and establishing fair prices. All
other concerns distract companies and interfere with achieving these goals.

**Unfairness** Whenever companies stray from their designated role of profit-maker, they take unfair advantage of company employees and shareholders. For example, a company may support the arts or education or spend excess funds on health and safety; however, these funds rightfully belong to the shareholders or employees. The company’s decision to disburse these funds to others who may well be less deserving than the shareholders and employees is unfair. Furthermore, consumers can express their desires through the marketplace, and shareholders and employees can decide privately if they wish to make charitable contributions. In most cases, senior management consults the board of directors about supporting social concerns but does not seek the approval of the company’s major stakeholders, thereby effectively disenfranchising these shareholders from actions that reduce their benefits from the corporation.

**Accountability** Corporations, as previously noted, are private institutions that are subject to a lower standard of accountability than are public bodies. Accordingly, a company may decide to support a wide range of social causes and yet submit to little public scrutiny. But a substantial potential for abuse exists in such cases. For one thing, a company could provide funding for a variety of causes its employees or shareholders did not support. It also could provide money “with strings attached,” thereby controlling the recipients’ agendas for less than socially beneficial purposes. For example, a drug company that contributes to a consumer group might implicitly or explicitly condition its assistance on the group’s agreement never to criticize the company or the drug industry.

This lack of accountability warrants particular concern because of the enormous power corporations wield in modern society. Many large companies, like General Motors or Exxon, generate and spend more money in a year than all but a handful of the world’s countries. If these companies suddenly began to vigorously pursue their own social agendas, their influence might well rival, and perhaps undermine, that of their national government. In a country like the United States, founded on the principles of limited government and the balance of powers, too much corporate involvement in social affairs might well present substantial problems. Without clear guidelines and accountability, companies pursuing their private visions of socially responsible behavior might well distort the entire process of governance.

There is a clear alternative to corporations engaging in socially responsible action. If society wishes to increase the resources devoted to needy causes, it has the power to do so. Let the corporations seek profits without the burden of a social agenda, let the consumers vote in the marketplace for the products and services they desire, and let the government tax a portion of corporate profits for socially beneficial causes.

**Expertise** Even though a corporation has an expertise in producing and selling its product, it may not possess a talent for recognizing or managing socially useful activities. Corporations become successful in the market because they can identify and meet the needs of their customers. Nothing suggests that this talent spills over into nonbusiness arenas. In fact, critics of corporate participation in social activities worry that corporations will prove unable to distinguish the true needs of society from their own narrow self-interests.

**Arguments in Favor of Social Responsibility**

First, it should be recognized that even the critics of business acknowledge that the prime responsibility of business is to make a reasonable return on its investment by producing a quality product at a reasonable price. They do not suggest that business entities be charitable institutions. They do assert, however, that business has certain obligations beyond making a profit or not harming society. Such critics contend that business must help to resolve societal problems, and they offer a number of arguments in support of their position.

[http://condor.depaul.edu/ethics/codes1.html](http://condor.depaul.edu/ethics/codes1.html)

**The Social Contract** Society creates corporations and gives them a special social status, including the granting of limited liability, which insulates owners from liability for debts their organizations incur. Supporters of social roles for corporations assert that limited liability and other rights granted to companies carry a responsibility: corporations, just like other members of society, must contribute to its betterment. Therefore, companies owe a moral debt to society to contribute to its overall well-being. Society needs a host of improvements, such as pollution control, safe products, a free marketplace, quality education, cures for illness, and freedom from crime. Corporations can help in each of these areas. Granted, deciding which social needs deserve corporate attention is difficult; however, this challenge does not lessen a company’s obligation to choose a cause. Corporate America cannot ignore the multitude of pressing needs that remain, despite the efforts of government and private charities.

A derivative of the social contract theory is the **stakeholder model** for the societal role of the business.
corporation. Under the stakeholder model a corporation has fiduciary responsibilities—duty of utmost loyalty and good faith—to all of its stakeholders, not just its stockholders. Historically, the stockholder model for the role of business has been the norm. Under this theory, a corporation is viewed as private property owned by and for the benefit of its owners—the stockholders of the corporation. (For a full discussion of this legal model, see Chapter 36.) The stakeholder model, on the other hand, holds that corporations are responsible to society at large and more directly to all those constituencies on which they depend for their survival. Thus, it is argued that a corporation should be managed for the benefit of all of its stakeholders—stockholders, employees, customers, suppliers, and managers, as well as the local communities in which it operates. (See Figure 2-2; compare it with Figure 36-1.)

**Less Government Regulation** According to another argument in favor of corporate social responsibility, the more responsibly companies act, the less the government must regulate them. This idea, if accurate, would likely appeal to those corporations that typically view regulation with distaste, perceiving it as a crude and expensive way of achieving social goals. To them, regulation often imposes inappropriate, overly broad rules that hamper productivity and require extensive recordkeeping procedures to document compliance. If companies can use more flexible, voluntary methods of meeting a social norm such as pollution control, then government will be less tempted to legislate norms.

The argument can be taken further. Not only does anticipatory corporate action lessen the likelihood of government regulation, but also social involvement by companies creates a climate of trust and respect that reduces the overall inclination of government to interfere in company business. For example, a government agency is much more likely to show some leniency toward a socially responsible company than toward one that ignores social plights.

**Long-Run Profits** Perhaps the most persuasive argument in favor of corporate involvement in social causes is that such involvement actually makes good business sense. Consumers often support good corporate images and avoid bad ones. For example, consumers generally prefer to patronize stores with “easy return” policies. Even though such policies are not required by law, companies institute them because they create goodwill—an intangible though indispensable asset for ensuring repeat customers. In the long run, enhanced goodwill often rebounds to stronger profits. Moreover, corporate actions to improve the well-being of their communities make these communities more attractive to citizens and more profitable for business.
CHAPTER SUMMARY

Definitions

**Ethics**  study of what is right or good for human beings
**Business Ethics**  study of what is right and good in a business setting

Ethical Theories

**Ethical Fundamentalism**  individuals look to a central authority or set of rules to guide them in ethical decision making
**Ethical Relativism**  asserts that actions must be judged by what individuals subjectively feel is right or wrong for themselves
**Situational Ethics**  one must judge a person’s actions by first putting oneself in the actor’s situation
**Utilitarianism**  moral actions are those that produce the greatest net pleasure compared with net pain
  - **Act Utilitarianism**  assesses each separate act according to whether it maximizes pleasure over pain
  - **Rule Utilitarianism**  supports rules that on balance produce the greatest pleasure for society
  - **Cost-Benefit Analysis**  quantifies the benefits and costs of alternatives
**Deontology**  holds that actions must be judged by their motives and means as well as their results
**Social Ethics Theories**  focus on a person’s obligations to other members in society and on the individual’s rights and obligations within society
  - **Social Egalitarians**  believe that society should provide all its members with equal amounts of goods and services regardless of their relative contributions
  - **Distributive Justice**  stresses equality of opportunity rather than results
  - **Libertarians**  stress market outcomes as the basis for distributing society’s rewards
**Other Theories**
  - **Intuitionism**  a rational person possesses inherent power to assess the correctness of actions
  - **Good Person**  individuals should seek out and emulate good role models

Ethical Standards in Business

Choosing an Ethical System  Kohlberg’s stages of moral development is a widely accepted model (See Figure 2-1.)

**Corporations as Moral Agents**  because a corporation is a statutorily created entity, it is not clear whether it should be held morally responsible

Ethical Responsibilities of Business

**Regulation of Business**  governmental regulation has been necessary because all the conditions for perfect competition have not been satisfied and free competition cannot by itself achieve other societal objectives
**Corporate Governance**  vast amounts of wealth and power have become concentrated in a small number of corporations, which are in turn controlled by a small group of corporate officers
Arguments Against Social Responsibility

1. Profitability: Because corporations are artificial entities established for profit-making activities, their only social obligation should be to return as much money as possible to shareholders.
2. Unfairness: Whenever corporations engage in social activities, such as supporting the arts or education, they divert funds rightfully belonging to shareholders and/or employees to unrelated third parties.
3. Accountability: A corporation is subject to less public accountability than public bodies are.
4. Expertise: Although a corporation may have a high level of expertise in selling its goods and services, there is absolutely no guarantee that any promotion of social activities will be carried on with the same degree of competence.

Arguments in Favor of Social Responsibility

1. The Social Contract: Because society allows for the creation of corporations and gives them special rights, including a grant of limited liability, corporations owe a responsibility to society.
2. Less Government Regulation: By taking a more proactive role in addressing society’s problems, corporations create a climate of trust and respect that has the effect of reducing government regulation.
3. Long-Run Profits: Corporate involvement in social causes creates goodwill, which simply makes good business sense.

Problems

1. You have an employee who has a chemical imbalance in the brain that causes him to be severely unstable. The medication that is available to deal with this schizophrenic condition is extremely powerful and decreases the taker’s life span by one to two years for every year that the user takes it. You know that his doctors and family believe that it is in his best interest to take the medication. What course of action should you follow?

2. You have an employee from another country who is very shy. After a period of time, you notice that the quality of her performance is deteriorating rapidly. You find an appropriate time to speak with her and determine that she is extremely distraught. She informs you that her family has arranged a marriage for her and that she refuses to obey their contract. She further informs you that she is contemplating suicide. Two weeks later, after her poor performance continues, you determine that she is on the verge of a nervous breakdown; and once again she informs you that she is going to commit suicide. What should you do? Consider further that you can petition a court to have her involuntarily committed to a mental hospital. You know, however, that such a commitment would be considered an extreme insult by her family and that they might seek retribution. Does this alter your decision?

3. You receive a telephone call from a company you never do business with requesting a reference on one of your employees, Mary Sunshine. You believe Mary performs in a generally incompetent manner and would be delighted to see her take another job. You give her a glowing reference. Is this right? Explain.

4. You have just received a report suggesting that a chemical your company uses in its manufacturing process is very dangerous. You have not read the report, but you are generally aware of its contents. You believe that the chemical can be replaced fairly easily, but that if word gets out, panic may set in among employees and community members. A reporter asks if you have seen the report, and you say no. Is your behavior right or wrong? Explain.

5. Joe Jones, your neighbor and friend, and you bought lottery tickets at the corner drugstore. While watching the lottery drawing on TV with you that night, Joe leaped from the couch, waved his lottery ticket, and shouted, “I’ve got the winning number!” Suddenly, he clutched his chest, keeled over, and died on the spot. You are the only living person who knows that Joe,
not you, bought the winning ticket. If you substitute his ticket for yours, no one will know of the switch and you will be $10 million richer. Joe's only living relative is a rich aunt whom he despised. Will you switch his ticket for yours? Explain.

6. Omega, Inc., a publicly held corporation, has assets of $100 million and annual earnings in the range of $13 to $15 million. Omega owns three aluminum plants, which are profitable, and one plastics plant, which is losing $4 million a year. Because of its very high operating costs, the plastics plant shows no sign of ever becoming profitable, and there is no evidence that the plant and the underlying real estate will increase in value. Omega decides to sell the plastics plant. The only bidder for the plant is Gold, who intends to use the plant for a new purpose, to introduce automation, and to replace all existing employees. Would it be ethical for Omega to turn down Gold's bid and keep the plastics plant operating indefinitely, for the purpose of preserving the employees' jobs? Explain.

7. You are the sales manager of a two-year-old electronics firm. At times, the firm has seemed on the brink of failure, but recently it has begun to be profitable. In large part, the profitability is due to the aggressive and talented sales force you have recruited. Two months ago, you hired Alice North, an honors graduate from the State University, who decided that she was tired of the Research Department and wanted to try sales.

Almost immediately after you sent Alice out for training with Brad West, your best salesperson, he began reporting to you an unexpected turn of events. According to Brad, “Alice is terrific: she's confident, smooth, and persistent. Unfortunately, a lot of our buyers are good old boys who just aren't comfortable around young, bright women. Just last week, Hiram Jones, one of our biggest customers, told me that he simply won't continue to do business with 'young chicks' who think they invented the world. It's not that Alice is a know-it-all. She's not. It's just that these guys like to booze it up a bit, tell some off-color jokes, and then get down to business. Alice doesn't drink, and, although she never objects to the jokes, it's clear she thinks they're offensive.” Brad felt that several potential deals had fallen through “because the mood just wasn't right with Alice there.” Brad added, “I don't like a lot of these guys' styles myself, but I go along to make the sales. I just don't think Alice is going to make it.”

When you call Alice in to discuss the situation, she concedes the accuracy of Brad's report but indicates that she's not to blame and insists that she be kept on the job. You feel committed to equal opportunity but don't want to jeopardize your company's ability to survive. What should you do?

8. Major Company subcontracted the development of part of a large technology system to Start-up Company, a small corporation specializing in custom computer systems. The contract, which was a major breakthrough for Start-up Company and crucial to its future, provided for an initial development fee and subsequent progress payments, as well as a final date for completion.

Start-up Company provided Major Company with periodic reports indicating that everything was on schedule. After several months, however, the status reports stopped coming, and the company missed delivery of the schematics, the second major milestone. As an in-house technical consultant for Major Company, you visited Start-up Company and found not only that it was far behind schedule but that it had lied about its previous progress. Moreover, you determined that this slippage put the schedule for the entire project in severe jeopardy. The cause of Start-up's slippage was the removal of personnel from your project to work on short-term contracts to obtain money to meet the weekly payroll.

Your company decided that you should stay at Start-up Company to monitor its work and to assist in the design of the project. After six weeks and some progress, Start-up is still way behind its delivery dates. Nonetheless, you are now familiar enough with the project to complete it in-house with Major's personnel.

Start-up is still experiencing severe cash flow problems and repeatedly requests payment from Major. But your CEO, furious with Start-up's lies and deceptions, wishes to “bury” Start-up and finish the project using Major Company's internal resources. She knows that withholding payment to Start-up will put it out of business. What do you do? Explain.

9. A customer requested certain sophisticated tests on equipment he purchased from your factory. Such tests are very expensive and must be performed by a third party. The equipment met all of the industry standards but showed anomalies, which could not be explained.

Though the problem appeared to be very minor, you decided to inspect the unit to try to understand the test data—a very expensive and time-consuming process. You informed the customer of this decision. A problem was found, but it was minor and was highly unlikely ever to cause the unit to fail. Rebuilding the equipment would be very expensive and time consuming; moreover, notifying the customer that you were planning to rebuild the unit would also put your overall manufacturing procedures in question. What should you do—fix it, ship it, inform the customer?
10. a. You are a project manager for a company making a major proposal to a Middle Eastern country. Your major competition is from Japan. Your local agent, who is closely tied to a very influential sheik, would receive a 5 percent commission if the proposal were accepted. Near the date for the decision, the agent asks you for $150,000 to grease the skids so that your proposal is accepted. What do you do?
b. What if, after you say no, the agent goes to your vice president, who provides the money? What do you do?
c. Your overseas operation learns that most other foreign companies in this Middle Eastern location bolster their business by exchanging currency on the gray market. You discover that your division is twice as profitable as budgeted due to the amount of domestic currency you have received on the gray market. What do you do?

Internet Exercise  Find and identify some web sites pertaining to business ethics that contain (a) political, social, or economic bias, (b) codes of conduct for companies, associations, or users, and (c) other significant material.
The business ethics cases that follow are based on the kinds of situations that companies regularly face in conducting business. You should first read each case carefully and in its entirety before attempting to analyze it. Second, you should identify the most important ethical issues arising from the situation. Often it is helpful to prioritize these issues. Third, you should identify the viable options for addressing these issues and the ethical implications of the identified options. This might include examining the options from the perspectives of the various ethical theories as well as the affected stakeholders. Fourth, you should reach a definite resolution of the ethical issues by choosing what you think is the best option. You should have a well-articulated rationale for your resolution. Finally, develop a strategy for implementing your resolution.

## Pharmakon Drug Company
### Background
William Wilson, senior vice president of research, development, and medical (R, D & M) at Pharmakon Drug Company, received both his Ph.D. in biochemistry and his M.D. from the University of Oklahoma. Upon completion of his residency, Dr. Wilson joined the faculty at Harvard Medical School. He left Harvard after five years to join the research group at Merck & Co. Three years later, he went to Burroughs-Wellcome as director of R, D & M, and, after eight years, Dr. Wilson joined Pharmakon in his current position.

William Wilson has always been highly respected as a scientist, a manager, and an individual. He has also been an outstanding leader in the scientific community, particularly in the effort to attract more minorities into the field.

Pharmakon concentrates its research efforts in the areas of antivirals (with a focus on HIV), cardiovascular, respiratory, muscle relaxants, gastrointestinal, the central nervous system, and consumer health care (that is, nonprescription or over-the-counter medicines). Dr. Wilson is on the board of directors of Pharmakon and the company’s executive committee. He reports directly to the chairman of the board and CEO, Mr. Jarred Swenstrum.

### Declining Growth
During the previous eight years, Pharmakon experienced tremendous growth: 253 percent overall with yearly growth ranging from 12 percent to 25 percent. During this period, Pharmakon’s R, D & M budget grew from $79 million to $403 million, and the number of employees rose from 1,192 to 3,273 (see Table 1). During the previous two years, however, growth in revenue and earnings had slowed considerably. Moreover, in the current year, Pharmakon’s revenues of $3.55 billion and earnings before taxes of $1.12 billion were up only 2 percent from the previous year. Furthermore, both revenues and earnings are projected to be flat or declining for the next five years.

The cessation of this period’s tremendous growth and the likelihood of future decline have been brought about principally by two causes. First, a number of Pharmakon’s most important patents have expired and competition from generics has begun and could continue to erode its products’ market shares. Second, as new types of health-care delivery organizations evolve, pharmaceutical companies’ revenues and earnings will in all likelihood be adversely affected.

## Table 1  Pharmakon Employment

<table>
<thead>
<tr>
<th>Attribute/Years Ago</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Employment</td>
<td>3,273</td>
<td>3,079</td>
<td>2,765</td>
<td>2,372</td>
<td>1,927</td>
<td>1,619</td>
<td>1,306</td>
</tr>
<tr>
<td>Minority Employment</td>
<td>(272)</td>
<td>(238)</td>
<td>(196)</td>
<td>(143)</td>
<td>(109)</td>
<td>(75)</td>
<td>(53)</td>
</tr>
<tr>
<td></td>
<td>(8.35%)</td>
<td>(7.7%)</td>
<td>(7.15%)</td>
<td>(6.0%)</td>
<td>(5.7%)</td>
<td>(4.6%)</td>
<td>(4.1%)</td>
</tr>
<tr>
<td>Revenue ($ million)</td>
<td>3,481</td>
<td>3,087</td>
<td>2,702</td>
<td>2,184</td>
<td>1,750</td>
<td>1,479</td>
<td>1,214</td>
</tr>
<tr>
<td>Profit ($ million)</td>
<td>1,106</td>
<td>1,021</td>
<td>996</td>
<td>869</td>
<td>724</td>
<td>634</td>
<td>520</td>
</tr>
<tr>
<td>R, D &amp; M Budget</td>
<td>403</td>
<td>381</td>
<td>357</td>
<td>274</td>
<td>195</td>
<td>126</td>
<td>96</td>
</tr>
</tbody>
</table>
Problem and Proposed Solutions

In response, the board of directors has decided that the company must emphasize two conflicting goals: increase the number of new drugs brought to market and cut back on the workforce in anticipation of rising labor and marketing costs and declining revenues. Accordingly, Dr. Wilson has been instructed to cut costs significantly and to reduce his workforce by 15 percent over the next six months.

Dr. Wilson called a meeting with his management team to discuss the workforce reduction. One of his managers, Leashia Harmon, argued that the layoffs should be made so that recent gains in minority hiring are not wiped out. The percentage of minority employees had increased from 2.7 percent eight years ago to 8.3 percent in the previous year (see Table 1). The minority population in communities in which Pharmakon has major facilities has remained over the years at approximately 23 percent. About 20 percent of the R, D & M workforce have a Ph.D. in a physical science or in pharmacology, and another 3 percent have an M.D.

Dr. Harmon, a Ph.D. in pharmacology and head of clinical studies, is the only minority on Dr. Wilson’s seven-member management team. Dr. Harmon argued that R, D & M has worked long and hard to increase minority employment and has been a leader in promoting Pharmakon’s affirmative action plan (see Figure 1). Therefore, she asserted, all layoffs should reflect this commitment, even if it meant disproportionate layoffs of nonminorities.

Dr. Anson Peake, another member of Dr. Wilson’s management team and director of new products, argued that Pharmakon’s R, D & M division has never discharged a worker except for cause and should adhere as closely as possible to that policy by terminating individuals solely based on merit. Dr. Rachel Waugh, director of product development, pointed out that the enormous growth in employment over the last eight years—almost a trebling of the workforce—had made the company’s employee performance evaluation system less than reliable. Consequently, she contended that because laying off 15 percent of her group would be extremely difficult and subjective, she preferred to follow a system of seniority.

Dr. Wilson immediately recognized that any system of reducing the workforce would be difficult to implement. Moreover, he was concerned about fairness to employees and maintaining the best qualified group to carry out the area’s mission. He was very troubled by a merit or seniority system if it could not maintain the minority gains. In fact, he had even thought about the possibility of using this difficult situation to increase the percentage of minorities to bring it more in line with the minority percentage of the communities in which Pharmakon had major facilities.

Figure 1
Pharmakon Affirmative Action Program

POLICY

It is the policy of Pharmakon Drug Co. to provide equal employment opportunities without regard to race, color, religion, sex, national origin, sexual preference, disability, and veteran status. The Company will also take affirmative action to employ and advance individual applicants from all segments of our society. This policy relates to all phases of employment, including, but not limited to, recruiting, hiring, placement, promotion, demotion, layoff, recall, termination, compensation, and training. In communities where Pharmakon has facilities, it is our policy to be a leader in providing equal employment for all of its citizens.

RESPONSIBILITY FOR IMPLEMENTATION

The head of each division is ultimately responsible for initiating, administering, and controlling activities within all areas of responsibility necessary to ensure full implementation of this policy. The managers of each location or area are responsible for the implementation of this policy. All other members of management are responsible for conducting day-to-day activities in a manner to ensure compliance with this policy.
Jack Spratt, the newly appointed CEO of Mykon Pharmaceuticals, Inc., sat at his desk and scratched his head for the thousandth time that night. His friends never tired of telling him that unless he stopped this habit he would remove what little hair he had left. Nevertheless, he had good reason to be perplexed—the decisions he made would determine the future of the company and, literally, the life or death of thousands of people.

As a young, ambitious scientist, Spratt had gained international fame and considerable fortune while rising quickly through the ranks of the scientists at Mykon. After receiving a degree from the Executive MBA program at the Kenan-Flagler Business School, University of North Carolina at Chapel Hill, he assumed, in rapid succession, a number of administrative positions at the company, culminating in his appointment as CEO. But no one had told him that finding cures for previously incurable diseases would be fraught with moral dilemmas. Although it was 3:00 in the morning, Spratt remained at his desk, unable to stop thinking about his difficult choices. His preoccupation was made worse by the knowledge that pressure from governments and consumers would only increase each day he failed to reach a decision. This pressure had mounted relentlessly since the fateful day he had announced that Mykon had discovered the cure for AIDS. But the cure brought with it a curse: there was not enough to go around.

**Company Background**

Mykon, a major international research-based pharmaceutical group, engages in the research, development, manufacture, and marketing of human health-care products for sale in both the prescription and over-the-counter (OTC) markets. The company’s principal prescription medicines include a range of products in the following areas: antiviral, neuromuscular blocking, cardiovascular, anti-inflammatory, immunosuppressive, systemic antibacterial, and central nervous system. Mykon also manufactures other products such as muscle relaxants, anti-depressants, anti-convulsants, and respiratory stimulants. In addition, the company markets drugs for the treatment of congestive heart failure and the prevention of organ rejection following transplant.

Mykon’s OTC business primarily consists of cough and cold preparations and several topical antibiotics. The company seeks to expand its OTC business in various ways, including the reclassification of some of its prescription drugs to OTC status. Mykon’s OTC sales represented 14 percent of the company’s sales during last year.

Mykon has a long tradition of excellence in research and development (R & D). The company’s expenditures on R & D for the last three financial years constituted 15 percent of its sales.

Mykon focuses its R & D on the following selected therapeutic areas, listed in descending order of expenditure amount: anti-virals and other antibiotics, cardiovascular, central nervous system, anti-cancer, anti-inflammatory, respiratory, and neuromuscular.

Mykon sells its products internationally in more than 120 countries and has a significant presence in two of the largest pharmaceutical markets—the United States and Europe—and a growing presence in Japan. It generated approximately 43 percent and 35 percent of the company’s sales from the previous year in the United States and Europe, respectively. The company sells essentially the same range of products throughout the world.

**Production**

Mykon carries out most of its production in Rotterdam in the Netherlands and in Research Triangle Park, North Carolina, in the United States. The latter is the company’s world headquarters. The company’s manufacturing processes typically consist of three stages: the manufacture of active chemicals, the incorporation of these chemicals into products designed for use by the consumer, and packaging. The firm has an ongoing program of capital expenditure to provide up-to-date production facilities and relies on advanced technology, automation, and computerization of its manufacturing capability to help maintain its competitive position.

Production facilities are also located in ten other countries to meet the needs of local markets and to overcome legal restrictions on the importation of finished products. These facilities principally engage in product formulation and packaging, although plants in certain countries manufacture active chemicals. Last year, Mykon had more than 17,000 employees, 27 percent of whom were in the United States. Approximately 21 percent of Mykon’s employees were engaged in R & D, largely in the Netherlands and the United States. Although unions represent a number of the firm’s employees, the firm has not experienced any significant labor disputes in recent years, and it considers its employee relations to be good.

**Research and Development**

In the pharmaceutical industry, R & D is both expensive and prolonged, entailing considerable uncertainty. The process of producing a commercial drug typically takes between eight and twelve years as it proceeds from discovery through development to regulatory approval and finally to the product launch. No assurance exists that new compounds will survive the development process or obtain the requisite regulatory approvals. In addition, research conducted by other
pharmaceutical companies may lead at any time to the introduction of competing or improved treatments.

Last year Mykon incurred approximately 95 percent of its R & D expenditures in the Netherlands and the United States. Figure 2 sets out the firm’s annual expenditure on R & D in dollars and as a percentage of sales for each of the last three financial years.

### Jack Spratt

Every society, every institution, every company, and most important, every individual should follow those precepts that society holds most dear. The pursuit of profits must be consistent with and subordinate to these ideals, the most important of which is the Golden Rule. To work for the betterment of humanity is the reason I became a scientist in the first place. As a child, Banting and Best were my heroes. I could think of no vocation that held greater promise to help mankind. Now that I am CEO I intend to have these beliefs included in our company’s mission statement.

These sentiments, expressed by Jack Spratt in a news magazine interview, capture the intensity and drive that animate the man. None who knew him was surprised when he set out years ago—fueled by his prodigious energy, guided by his brilliant mind, and financed by Mykon—for the inner reaches of the Amazon Basin to find naturally occurring medicines. Spratt considered it to be his manifest destiny to discover the cure for some dread disease.

His search was not totally blind. Some years earlier, Frans Berger, a well-known but eccentric scientist, had written extensively about the variety of plant life and fungi that flourished in the jungles of the Bobonaza River region deep in the Amazon watershed. Although he spent twenty years there and discovered nothing of medical significance, the vast number and intriguing uniqueness of his specimens convinced Spratt that it was just a matter of time before a major breakthrough would occur.

Spratt also had some scientific evidence. While working in Mykon’s laboratory to finance his graduate education in biology and genetics, Spratt and his supervisors had noticed that several fungi could not only restore damaged skin but, when combined with synthetic polymers, had significant effects on internal cells. Several more years of scientific expeditions and investigations proved promising enough for Mykon to send Spratt and a twenty-person exploration team to the Amazon Basin for two years. Two years became five, and the enormous quantity of specimens sent back eventually took over an entire wing of the company’s sizable laboratories in Research Triangle Park, North Carolina.

Upon Spratt’s return, he headed up a group of Mykon scientists who examined the Amazonian fungi for pharmacological activity. After several years of promising beginnings and disappointing endings, they discovered that one fungus destroyed the recently identified virus HIV. Years later, the company managed to produce enough of the drug (code named Sprattalin) derived from the fungus to inform the Food and Drug Administration (FDA) that it was testing what appeared to be a cure for HIV. It was the happiest moment of Jack Spratt’s life. The years of determined effort, not to mention the $800 million Mykon had invested, would now be more than fully rewarded.

Spratt’s joy was short lived, though. Public awareness of the drug quickly spread, and groups pressured the FDA to shorten or eliminate its normal approval process, which ordinarily
takes more than seven years. People dying from the virus's effects demanded immediate access to the drug.

**The Drug**

Mirroring the insidiousness of HIV itself, the structure of Sprattalin is extraordinarily complex. Consequently, it takes four to seven months to produce a small quantity, only 25 percent of which is usable. It is expensive; each unit of Sprattalin costs Mykon $20,000 to produce. The projected dosage ranges from ten units for asymptomatic HIV-positive patients who have normal white blood cell counts to fifty units for patients with low white blood cell counts and full-blown AIDS. The drug appears to eliminate the virus from all patients regardless of their stage of the disease. However, it does not have any restorative effect on patients’ compromised immune systems. Accordingly, it is expected that asymptomatic HIV-positive patients will revert to their normal life expectancies. It is not clear what the life expectancy will be of patients with full-blown AIDS, although it is almost certain that their life expectancy would be curtailed.

**Supply of Sprattalin** The company has estimated that the first two years of production would yield enough Sprattalin to cure 20 percent of all asymptomatic HIV-positive patients. Alternatively, the supply would be sufficient to treat 14 percent of all patients with full-blown AIDS.

Interested parties have argued that the solution to production problems is clear: build larger facilities. However, even with production levels as low as they are, the bottleneck in supply occurs elsewhere. The fungus on which the whole process depends is incredibly rare, growing only in two small regions near Jatun Molino, Ecuador, along the Bobonaza River. At current harvesting rates, scientists predict that all known deposits will be depleted in three years, and many of them insist that production should be scaled back to allow the fungus to regenerate itself.

Presently there are no known methods of cultivating the fungus in the laboratory. Apparently, the delicate ecology that allows it to exist in only one region of the earth is somehow distressed enough by either transport or lab conditions to render it unable to grow and produce the drug's precursor. Scientists are feverishly trying to discover those factors that will support successful culture. However, with limited quantities of the starting material and most of that pressured into production, the company has enjoyed no success in this endeavor. Because of Sprattalin's complexity, attempts to synthesize the drug have failed completely, mainly because, like aspirin, it is not known how the drug works; thus, Sprattalin's effectiveness remains shrouded in mystery.

**Allocation of Sprattalin** In response to the insufficient supply, a number of powerful consumer groups have made public their suggestions regarding the allocation of Sprattalin. One proposition advanced would use medical records to establish a waiting list of possible recipients based on the length of time they have been in treatment for the virus. The argument is that those people who have waited the longest and are most in danger of dying should be the first to find relief.

Other groups propose an opposite approach, arguing that because supply is so drastically short, Mykon should make Sprattalin available only to asymptomatic HIV patients. They require the least concentrations of the drug to become well, thus extending the drug's supply. They also have the greatest likelihood of returning to full life expectancies. Under this proposal, people who have full-blown AIDS would be ineligible for treatment. Such patients have previously come to terms with their impending mortality, have fewer psychological adjustments to make, and represent, on a dosage basis, two to five healthier patients. In meting the drug out in this manner, proponents argue, the drug can more readily meet the highest public health objectives to eradicate the virus and prevent further transmission.

Others propose that only patients who contracted the virus through no fault of their own should have priority. This approach would first make Sprattalin available to children who were born with the virus, hemophiliacs and others who got the virus from blood transfusions, rape victims, and health-care workers.

One member of Sprattalin's executive committee has suggested a free market approach: the drug should go to the highest bidder.

**Pricing of Sprattalin** In addition to supply problems, Mykon has also come under considerable criticism for its proposed pricing structure. Because of extraordinarily high development and production costs, the company has tentatively priced the drug at levels unattainable for most people afflicted with HIV. Perhaps never before in the history of medicine has the ability to pay been so starkly presented as those who can pay, live, while those who cannot, die.

Even at these prices, though, demand far exceeds supply. Jack Spratt and the rest of the Mykon executives predict that the company could easily sell available supplies at twice the proposed price.

A growing number of Mykon executives disagree with the passive stance the company has taken in pricing the product. In their view, a 20 percent markup represents a meager return for the prolonged risk and high levels of spending that the company incurred to develop the drug. Moreover, it leaves little surplus for future investment. Furthermore, eight years is too long to amortize the R & D expenses because Sprattalin, though the first, is unlikely to be the last anti-HIV drug, now that Mykon has blazed a path. Other, more heavily capitalized companies are racing to reverse engineer the drug, and the availability of competing drugs remains only a matter of time. Accordingly, the company cannot realistically count on an eight-year window of opportunity.
Making the Decision

In the last few months, Jack Spratt had seen many aspects of the most important project in his life become not only public knowledge but also public domain. Because of the enormous social and political consequences of the discovery, it is unlikely that the government will allow Mykon to control the destiny of either Sprattalin or ultimately the company.

Addressing the public's concern over access to the drug while ensuring future prosperity of his company had become like walking a tightrope with strangers holding each end of the rope. He knew of no way to satisfy everyone. As Jack Spratt sat at his desk, sleep remained an eon away.

Foreign markets further exacerbate the pricing perplexity. Other countries, with less privatized health care, have already promised their citizens access to Sprattalin at any price. Some first world countries, for instance, are willing to pay up to $2 million per patient. They do not, however, wish to subsidize the drug for the United States. At the same time, some voices in the United States insist that supplies should go first to U.S. citizens.

On the other hand, countries with the most severe concentration of the HIV infection cannot afford to pay even Mykon's actual costs. Some regions in Africa and Asia have experienced rapid growth of the disease, reporting 50 percent to 80 percent of their population at some stage in the HIV cycle. Jack Spratt feels a very real moral obligation to help at least some of these people, whether they can pay or not.

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Addressing the public's concern over access to the drug while ensuring future prosperity of his company had become like walking a tightrope with strangers holding each end of the rope. He knew of no way to satisfy everyone. As Jack Spratt sat at his desk, sleep remained an eon away.

Foreign markets further exacerbate the pricing perplexity. Other countries, with less privatized health care, have already promised their citizens access to Sprattalin at any price. Some first world countries, for instance, are willing to pay up to $2 million per patient. They do not, however, wish to subsidize the drug for the United States. At the same time, some voices in the United States insist that supplies should go first to U.S. citizens.

On the other hand, countries with the most severe concentration of the HIV infection cannot afford to pay even Mykon's actual costs. Some regions in Africa and Asia have experienced rapid growth of the disease, reporting 50 percent to 80 percent of their population at some stage in the HIV cycle. Jack Spratt feels a very real moral obligation to help at least some of these people, whether they can pay or not.

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**CHAPTER 2 BUSINESS ETHICS**

Stabler: For the convenience of consumers.
Menendez: Why would pensioners want a small bottle?
Calvin: Homeless people want it in pints so they can fit it in their hip pockets. They obviously don’t have a wine cellar to lay away their favorite bottles of Mad Dog.

Stabler: The pint size also keeps the price as low as possible.
Calvin: Translation: The homeless don’t have to panhandle as long before they can make a purchase. Also, why would you increase the alcoholic content to 18 percent and make it so sweet if it weren’t for the wino market?

Stabler: Many people like sweet dessert wines and 18 percent is not that much more than other types of wines that have 12 percent alcohol.

Menendez: Is it legal?
Lane: Sure. We sell to the retailers. It may be against the law to sell to intoxicated persons, but that’s the retailers’ business. We cannot control what they do.

Calvin: Isn’t this product intended for a perpetually intoxicated audience that many people consider to be ill? Wouldn’t we be taking advantage of their illness by selling highly sugared alcohol that suppresses their appetite? I’ve spoken to drinkers who claim to live on a gallon of this type of product a day.

Oliver, Jr.: What will this do to our image? We’re still trying to get our premium wines accepted.

Stabler: Of course we won’t use the Oliver name on these wines. We will use another name.

Menendez: Why not? Canandaigua, Gallo, and Mogen David all do the same thing. None of them put their corporate name on this low-end product.

Abbott: We’re getting away from the crux of the matter. Profit margins would be at least 10 percent higher on this line than our others. Moreover, unit sales might increase over time. Our other lines are stagnant or decreasing. The public shareholders are grousing.

Dale: Not to mention that our stock options have become almost worthless. I’m only a few years from retirement. We need to increase the profitability of the company.

Ray: Operationally, this proposal is a great fit. We can use the grapes we reject from the premium line. It will also insulate us from bad grape years because any grape will do for this wine. We can fill a lot of our unused capacity.

Constable: And hire back some of the workers who were laid off!

Stabler: It’s a marketing dream. Just give out some samples to “bell cows.”

Menendez: What are bell cows?
Stabler: Opinion leaders who will induce other consumers to switch to our brand.

Calvin: You mean wino gurus?

O liver, Sr.: Look, if we don’t do it, others will. In fact, they already have.

Lane: And they’ll get richer and we’ll get poorer.

Lane: Gallo pulled out of several of these skid row markets as did Canandaigua. Little good it did. The alcoholics just switched to malt liquor, vodka, or anything they could get their hands on.

Dale: I think our concern is misplaced. These people are the dregs of society. They contribute nothing.

Calvin: They’re human beings who need help. We’re profiting off their misfortune and misery.

O liver, Sr.: We can take that up when we decide on what charities to support. Anyone opposed to the proposal?

Calvin: Is this a done deal? I believe we should contribute half of our profits from this product to support homeless shelters and other programs that benefit indigent and homeless people. If not, I must resign from this board.

**Sources**


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**JLM, Inc.**

**Background**

Sitting in her office, Ellen Fulbright, director of human resources for JLM, Inc., thought over the decisions confronting her. To help her decide, she mentally reviewed how they had arisen.

After receiving her MBA and J.D. degrees from a highly regarded university, she joined a prestigious New York law firm where she specialized in employment law. After seven years at the law firm, she was hired by one of the firm’s clients as general counsel. When that company was acquired by JLM, she joined its legal staff and within a few years had been promoted to her current position.

Fulbright’s rapid advancement resulted from her having made a positive impression on Rasheed Raven, JLM’s CEO. Raven is a hard-driving, bottom-line-oriented pragmatist in his early forties. Raven, a graduate of Howard University, had begun his business career on Wall Street, which he astounded by his aggressive but successful takeover strategies. After acquiring fifteen unrelated manufacturing companies,
he decided to try his hand at the turnaround business. He organized JLM as an umbrella for his acquired companies. Soon he earned the reputation as the best in the business by transforming JLM into the leader in the industry.

JLM is a highly successful turnaround company. Typically, JLM purchases companies that are in serious financial trouble and manages them until they become successful companies. At that time, JLM either retains them in its own portfolio of companies or sells them off to other enterprises.

Reference Letter Policy

About a year after Fulbright had become director of human resources (H R), Raven called her into his office and showed her a newspaper article. It reported, in somewhat sensational fashion, that several defamation suits had resulted in multimillion dollar judgments against companies that had written negative letters of references about former employees. Raven told her that he was concerned about this and that he wanted her to develop an HR policy covering letters of reference.

In researching the issue, she discovered several articles in which the authors decried the recent spate of companies that had decided to stop writing letters of reference. According to their data, they believed that these companies had overreacted to the actual risk posed by defamation suits. Based on these articles and her own inclination toward full disclosure, she proposed that the company continue to permit letters of reference but that all letters with negative comments must be reviewed by her.

Raven did not receive her proposal favorably and sought a second opinion from her old law firm. His analysis of the firm's advice was: “We get nothing but brownie points for writing reference letters, but we face the possibility of incurring the cost of a legal defense or, worse yet, a court judgment. This is a ‘no-brainer.’ We have no upside and all downside.” Raven ordered that, henceforth, company employees would no longer write letters of reference but would simply verify dates of employment.

Although Fulbright was personally and professionally miffed by his decision, she drew up the policy statement as directed. Fulbright believed that because JLM frequently took over companies that needed immediate downsizing, this policy would be unfair and extremely detrimental to longtime employees of newly purchased companies.

Takeover of Diversified Manufacturing, Inc.

After a number of years of steady growth, Diversified Manufacturing began experiencing huge financial losses and its immediate survival was in serious doubt. After careful consideration, Raven decided that Diversified was an ideal takeover target in that its core businesses were extremely strong and presented great long-term economic viability.

Upon acquiring Diversified, JLM quickly decided that it had to rid Diversified of some of its poorly performing companies and that it had to reduce the size of Diversified’s home office staff by 25 percent. Raven relentlessly orchestrated the reduction in force, but at Fulbright’s urging he provided the discharged executives with above average severance packages, including excellent outplacement services.

The Problem

The reduction in force was disruptive and demoralizing in all the usual ways. But for Fulbright there was a further complication: the no reference letter policy. She was extremely troubled by its application to three discharged Diversified employees and to one discharged JLM employee.

The Salacious Sales Manager

Soon after taking over Diversified, Fulbright became all too aware of the story of Ken Byrd, Diversified’s then national sales manager. Ken is an affable man of fifty who had been an unusually effective sales manager. Throughout his career, his sales figures had always doubled those of his peers. He achieved rapid advancement despite a fatal flaw: he is an inveterate and indiscreet womanizer. He could not control his hands, which slapped backs so well, nor his tongue, which persuaded so eloquently. He had two approaches to women. With a woman of equal or superior rank in the company, he would politely, but inexorably, attempt to sweep her off her feet. With these women, he would be extremely charming and attentive, taking great care to avoid being offensive or harassing. In contrast, with a woman of subordinate rank, he would physically harass her. Less openly, but much too often, he would come up behind a woman, reach around her, and grab her. He invariably found this amusing—his victims, however, did not.

Fulbright could not believe that such a manager had stayed employed at Diversified so long, let alone been continually promoted to positions of greater responsibility and power. As Fulbright investigated the situation, she discovered that numerous sexual harassment complaints had been filed with Diversified concerning Byrd’s behavior. To protect Byrd, Diversified dealt with these complaints by providing money and undeserved promotions to the complainants to smooth over their anger. Thus, Diversified successfully kept the complaints in-house and away from the courts and the Equal Employment Opportunity Commission.

After JLM’s takeover of Diversified, Fulbright quickly discharged Byrd. Her satisfaction in getting rid of him was short lived, however. His golden tongue and stellar sales record had landed him several job offers. Her dilemma was that she was uncomfortable about loosing this deviant on an unsuspecting new employer. But JLM’s policy forbade her from writing any letters or answering questions from prospective employers.
The Fruitless Juice  Melissa Cuthbertson had been a vice president in procurement for Diversified’s Birch-Wood division with direct responsibility over the ordering of supplies and raw materials. Birch-Wood manufactured a full line of baby food products, including fruit juices that were labeled “100% fruit juice.” To cut costs, Stanley Aker, the division’s president, had arranged for an unscrupulous supplier to provide high-fructose corn syrup labeled as juice concentrate. Because standard testing in the industry was unable to detect the substitution, the company did not get caught. Emboldened, Aker gradually increased the proportion of corn syrup until there were only trace amounts of fruit juice left in the “juice.” A company employee discovered the practice and after the takeover brought the matter to Fulbright’s attention through JLM’s internal whistleblowing channel, which Fulbright had established. She referred the matter to Raven, who called Aker and Cuthbertson in and confronted them with the accusation. They admitted it all, explaining that nutritionally the corn syrup was equivalent to the fruit juice. But at 60 percent of the cost of fruit juice, the corn syrup made a big difference to the bottom line. Raven told them that such conduct was not permitted and that they must properly dispose of the adulterated juice.

That night Aker and Cuthbertson had the juice moved from Birch-Wood’s New York warehouse and shipped to its Puerto Rico warehouse. Over the course of the next few days, the “juice” was sold in Latin America as “apple juice.” Aker reported to Raven that the juice had been properly disposed of and that Birch-Wood had sustained only a small loss during that quarter. When Raven discovered the truth, he immediately discharged Aker and Cuthbertson, telling them “that if he had anything to do with it, neither of them would ever work again.” Fulbright referred the matter to Raven, who called Aker and Cuthbertson in and confronted them with the accusation. They admitted it all, explaining that nutritionally the corn syrup was equivalent to the fruit juice.

The Compassionate CFO  Jackson Cobb, JLM’s former chief financial officer, is a brilliant analyst. Through hard work he had earned an excellent education that honed his innate mathematical gifts. His natural curiosity led him to read widely, and this enabled him to bring disparate facts and concepts to bear on his often novel analyses of financial matters. But he had no interest in implementing his insights, for his only enjoyment was the process of discovering connections. Fortune—or fate—had brought him together with Raven, who is twenty years younger than Cobb. Theirs was definitely a case of opposites attracting. Raven cared little about ideas; he cared primarily about money. Cobb cared little about money; he cared primarily about ideas. Raven took Cobb’s insights and translated them into action with spectacular success. Their relationship brought new meaning to the concept of synergy.

When Raven formed JLM, he brought Cobb on as chief financial officer and installed him in an adjoining office. Their relationship continued to flourish, as did JLM’s bottom line, until Cobb’s wife became terminally ill. During the eighteen months she languished, Cobb spent as much time as he could taking care of her. After forty years of marriage, he was unwilling to leave her welfare to the “kindness of strangers.” At his own expense, he installed a state-of-the-art communication center in his home. By virtue of computers, modems, video cameras, faxes, copiers, mobile telephones, and the like, he had available to him the same data and information as he had at his office. He could be reached by telephone at all times. But he was not in the office next to Raven; he was not present at Raven’s daily breakfast meetings; he was not on the corporate jet en route to business meetings. After their many years of working together, Raven was enraged at the loss of immediate access to Cobb. He felt that Cobb had betrayed him and demanded that Cobb resume his old working hours. Cobb refused, and Raven fired him. Because of his age, Cobb was experiencing difficulty in finding new employment, and Fulbright wanted to write a letter on his behalf.

Sword Technology, Inc.

Background

Sitting in his office, Stephen Hag, CEO of Sword Technology, Inc., contemplated the problems that had been perplexing him for some time now. They had begun when he took his company international, and they kept coming. But today he was no more successful in devising a solution than he had been previously. Slowly, his thoughts drifted to those early days years ago when he and his sister Marian started the company.

The company’s first product was an investment newsletter stressing technical analysis in securities investing. A few years later, he developed what became a “killer app”: a computer program that defines an entirely new market and through customer loyalty substantially dominates that market. His software program enabled investors to track their investments in stocks, bonds, and futures. By combining powerful analytical tools with an accessible graphical interface, it appealed to both professional and amateur investors. Moreover, it required users to download information from the company’s database. With one of the most extensive databases and the cheapest downloading rates in the industry, the company soon controlled the U.S. market. Sword then went public through
a highly successful IPO (an initial public offering of the company’s common stock), and its stock is traded on the over-the-counter market. The company is required to file periodic reports with the Securities and Exchange Commission.

The company used cash from sales of software, on-line charges, and the IPO to try to enter the hardware side of the computer industry. It began manufacturing modems and other computer peripherals. A nagging problem, however, plagued the company’s manufacturing efforts. Although Sword’s modem could convert data more quickly and efficiently than most of its competitors, because of high labor costs it was unable to market its modem successfully. To reduce manufacturing costs, especially labor costs, the company decided to move its manufacturing facilities overseas. And that’s when the trouble began.

Stephen’s thoughts returned to the present. He reopened the folder labeled “Confidential: International Issues” and began perusing its contents.

**Transfer Pricing**

The first item he saw was an opinion letter from the company’s tax attorney. It dealt with Excalibur Technology, the first overseas company Sword established. Excalibur, a wholly owned subsidiary of Sword, is incorporated in Tolemac, an emerging country with a rapidly growing economy. To encourage foreign investment, Tolemac taxes corporate profits at a significantly lower rate than the United States and other industrialized nations. Excalibur manufactures modems for Sword pursuant to a licensing agreement under which Excalibur pays Sword a royalty equal to a specified percentage of the modems’ gross sales. Excalibur sells all of its output at a fair market price to Sword, which then markets the modems in the United States. Stephen had been closely involved in structuring this arrangement and had insisted on keeping the royalty rate low to minimize taxable income for Sword. Stephen reread the opinion letter:

Section 482 of the Internal Revenue Code authorizes the Internal Revenue Service to allocate gross income, deductions, credits, and other common allowances among two or more organizations, trades, or businesses under common ownership or control whenever it determines that this action is necessary “in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.” IRS Regulation 1.482-2(e) governing the sale or trade of intangibles between related persons mandates an appropriate allocation to reflect the price that an unrelated party under the same circumstances would have paid, which normally includes profit to the seller. The Regulations provide four methods for determining an arm’s length price. In our opinion, under the only method applicable to the circumstances of Sword Technology, Inc., and Excalibur Technology, the royalty rate should be at least three times the current one. If the IRS were to reach the same conclusion, then the company would be liable for the taxes it underpaid because of the understatement of income. Moreover, the company would be liable for a penalty of either 20 percent or 40 percent of the tax deficiency, unless the company can show that it had reasonable cause and acted in good faith.

Stephen had spoken to the tax attorney at length and learned that the probability of an audit was about 10 percent and that many multinational companies play similar “games” with their transfer pricing. The attorney also told him that he believed that if the company were audited, there was at least a 90 percent probability that the IRS would agree with his conclusion and at least a 70 percent probability that it would impose a penalty. Because the dollar amount of the contingent tax liability was not an insignificant amount, Stephen had been concerned about it for the six weeks since he had received the letter.

**Customs and Customs**

Soon after Excalibur had manufactured the first shipment of modems, a new problem arose: getting them out of Tolemac. It took far too long to clear customs, thus undermining their carefully planned just-in-time manufacturing schedules. Stephen hired a local export broker, who distributed cash gifts to customs officials. Miraculously, the clearance time shortened and manufacturing schedules were maintained. The export broker billed the company for his services and the amount of the cash gifts. Although the broker assured Stephen that such gifts were entirely customary, Stephen was not entirely comfortable with the practice.

**The Thorn in His Side**

Tolemac was not Stephen’s only problem. Six months after commencing operations in Tolemac, Sword began serious negotiations to enter the Liarg market. Liarg is an undeveloped country with a large population and a larger national debt. Previously, Sword had encountered great difficulties in exporting products to Liarg. Stephen’s sister, Marian, COO of Sword, took on the challenge of establishing a Liarg presence.

They decided that setting up a manufacturing facility in Liarg would achieve two objectives: greater access to the Liarg marketplace and lower-cost modems. At first, the Liarg government insisted that Sword enter into a joint venture, with the government having a 51 percent interest. Sword was unwilling to invest in such an arrangement, countering with a proposal for a wholly owned subsidiary. Marian conducted extensive negotiations with the government, assisted by a Liarg consulting firm that specialized in lobbying governmental officials. As part of these negotiations, Sword made contributions to the reelection campaigns of key Liarg legislators who were opposed to wholly owned subsidiaries of foreign corporations. After the legislators’ reelection, the negotiations quickly reached a successful conclusion. On closing the contract, Sword flew several Liarg officials and
their wives to Lake Tahoe for a lavish, three-day celebration. All of these expenses were reported in the company’s financial statements as payments for legal and consulting fees.

Marian then hired an international engineering firm to help design the manufacturing plant. Two weeks later, they submitted plans for the plant and its operations that fully complied with Liarg regulations regarding worker health and safety as well as environmental protection. But, as Marian had explained to Stephen, the plant’s design fell far short of complying with U.S. requirements. Marian noted that, under the proposed design, the workers would face exposure to moderately high levels of toxic chemicals and hazardous materials. The design also would degrade the water supply of nearby towns. However, the design would generate very significant savings in capital and operational costs as compared with the design used in their U.S. facility. Marian assured Stephen that all quality control systems were in place so the modems produced in this plant would be indistinguishable from their U.S. counterparts. Stephen and Marian have had long discussions about what to do about the plant.

Stephen then took from the folder an article that had appeared in a number of U.S. newspapers.

**Children and Chips**

A twelve-year-old Liarg child recently spoke at an international conference in New York denouncing the exploitation of children in the Liarg computer chip industry. The child informed the outraged audience that he had worked in such a plant from age four to age ten. He asserted that he was just one of many children who were so employed. He described the deplorable working conditions: poor ventilation, long hours, inadequate food, and substandard housing. The pay was low. But, because their families could not afford to keep them at home, the children were hired out to the factory owners, who especially wanted young children because their small fingers made them adept at many assembly processes.

Stephen had read the article countless times, thinking about his own children. He knew that if they set up a plant in Liarg, they would have to buy chip components from Liarg suppliers. He also knew that there would be no way for Sword to ensure that the chips had not been made with child labor.

He was also troubled by another labor issue. Marian told him that she had met considerable resistance from the Liarg executives they had hired when she suggested that women should be hired at the supervisory level. They maintained that it was not done and would make it impossible to hire and control a satisfactory workforce at the plant. Moreover, they insisted on hiring their relatives as supervisors. When Marian protested this nepotism, they assured her that it was customary and asserted that they could not trust anyone not related to them.

On top of all these concerns had come a letter from the company’s outside legal counsel regarding payments made to foreign officials.

**Memorandum of Law**

The Foreign Corrupt Practices Act makes it unlawful for any domestic company or any of its officers, directors, employees, or agents or its stockholders acting on its behalf to offer or give anything of value directly or indirectly to any foreign official, political party, or political official for the purpose of

1. influencing any act or decision of that person or party in his or its official capacity,
2. inducing an act or omission in violation of his or its lawful duty, or
3. inducing such person or party to use its influence to affect a decision of a foreign government in order to assist the domestic concern in obtaining or retaining business.

An offer or promise to make a prohibited payment is a violation even if the offer is not accepted or the promise is not performed. The 1988 amendments explicitly excluded facilitating or expediting payments made to expedite or secure the performance of routine governmental actions by a foreign official, political party, or party official. Routine governmental action does not include any decision by a foreign official regarding the award of new business or the continuation of old business. The amendments also added an affirmative defense for payments that are lawful under the written laws or regulations of the foreign official’s country. Violations are punishable by fines of up to $2 million for companies; individuals may be fined a maximum of $100,000 or imprisoned up to five years, or both. Fines imposed upon individuals may not be paid directly or indirectly by the domestic company on whose behalf they acted. In addition, the courts may impose civil penalties of up to $10,000.

The statute also imposes internal control requirements on all reporting companies. Such companies must

1. make and keep books, records, and accounts, that in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; and
2. devise and maintain a system of internal controls that ensure that transactions are executed as authorized and recorded in conformity with generally accepted accounting principles, thereby establishing accountability with regard to assets and ensuring that access to those assets is permitted only with management’s authorization.

Any person who knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies any book, record, or account is subject to criminal liability.