Professionalism, Agency, and Market Failures

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ABSTRACT: According to the *market failures approach* to business ethics, beyond-compliance duties can be derived by employing the same rationale and arguments that justify state regulation of economic conduct. Very roughly, the idea is that managers have a duty to behave as if they were complying with an ideal regulatory regime ensuring Pareto-optimal market outcomes. Proponents of the approach argue that managers have a *professional duty* not to undermine the institutional setting that defines their role, namely the competitive market. This answer is inadequate, however, for it is the hierarchical firm, rather than the competitive market, that defines the role of corporate managers and shapes their professional obligations. Thus, if the obligations that the market failures approach generates are to apply to managers, they must do so in an indirect way. I suggest that the obligations the market failures approach generates directly apply to shareholders. Managers, in turn, inherit these obligations as part of their duties as loyal agents.

KEY WORDS: market failures approach, professionalism, professional ethics, agency ethics, Joseph Heath, Kenneth Goodpaster

IN A SERIES OF RECENT ARTICLES, a handful of authors, including most prominently Joseph Heath, have begun to develop a new approach to business ethics (Brown, 2013; Heath, 2004, 2006, 2007, 2011, 2013, 2014; Norman, 2011). While the approach has been defended and developed under at least three different labels, it is most widely known as the *market failures approach* (Heath, 2004, 2006, 2011, 2014).[1] According to this approach, the mark of unethical behaviour in a business context is that it exploits and/or exacerbates imperfections in the way the market is set up. In particular, the approach declares it unethical to behave in ways that undermine the tendency of markets to allocate resources efficiently. In keeping with much of the contemporary business ethics literature, proponents of the market failures approach have been focused on the obligations of corporate managers.[2] The market failures approach is construed as providing the foundation of a professional ethics code for such managers. These professional obligations, in turn, may conflict with the fiduciary duties that managers are commonly thought to have towards the residual claimants on the profits of their firm (typically shareholders) (see, e.g. Brown, 2013).

I am generally sympathetic to the market failures approach and I agree that managerial obligations are best understood as part of a professional code. But the way these two elements have been combined by proponents of the market failures approach is inadequate. Heath and others have suggested that managers are subject

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to the prohibition against the exploitation of market failures in virtue of the role they play within the context of competitive markets. By contrast, I argue that the institution of the market is not as definitive of the professional role of the manager as this picture makes it out to be. Managers, I argue, are first and foremost agents and act in competitive markets only on behalf of their employers. It is thus the institution of the hierarchical firm, and specifically the division of ownership and control, that shapes the professional role of the manager. However, being the loyal agent of another party is a two-sided affair. On the one hand, it implies that one generally ought to pursue the interest of one's principal. This is what the much-maligned shareholder theory of business ethics gets right. On the other hand, an agent can only act permissibly within the confines of what is permissible for the principal her/himself. Hiring an agent should not be thought to create moral loopholes. Thus, I argue that the obligations formulated by the market failures approach apply in the first instance to shareholders, rather than to managers, for it is shareholders who are seeking to further their own self-interest via market competition. Managers, insofar as they are agents of shareholders, inherit those obligations through the agency relationship.

Thus, a readjustment of the market failures approach is in order. Its principles are best understood as applying to shareholders, who directly seek to profit from market exchanges rather than to managers *qua* managers who do so only indirectly. However, insofar as managers are acting on behalf of shareholders, they are bound by those very same obligations. This last point is one that Kenneth Goodpaster has emphasized in his seminal paper, "Business Ethics and Stakeholder Analysis" (1991). But while Goodpaster gets this part right, his account of the duties and obligations that are transmitted from shareholders to managers disappoints. He suggests that all that managers inherit from shareholders are the moral duties of everyday life. But this ignores the fact that business takes place in a competitive arena where such duties may be altered.

I propose to combine the most promising aspects of Goodpaster and Heath. While the former supplies the mechanism by which managers come to be bound by professional duties, the latter adds a framework for understanding the content of these duties. The main advantage of this picture over the market failures approach as typically conceived is that it can link the prohibitions against exploiting market failures with a framework that provides a plausible account of the nature of managerial work, an account that is already widely accepted by both scholars and managers themselves. In so doing my view closes the door for an excuse that managers who violate their duties will be tempted to make. A manager who acted in ways that undermine the efficiency of the market may claim that they did so out of loyalty to their employers. They would portray their choice as one of violating one set of duties in order to fulfill another. This description would be in keeping with the market failures approach. On my view, by contrast, there can be no conflict between the duties of loyalty and the duties generated by the market failures approach, and a manager who violated the latter could not claim to have acted as a loyal agent. For part of what it means to do so is to refrain from morally compromising one's principal.

The paper proceeds as follows. In the next section, I briefly sketch the market failures approach and its distinctive strengths. In section 2, I discuss at some length

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in what sense corporate managers are professionals. Here I argue that the market failures approach cannot directly inform a professional code that managers ought to feel bound by. Instead, as I explain in section 3, the approach is best understood as applying to shareholders. In section 4, I consider the objection that the market failures approach, once reformed according to my suggestions, is particularly vulnerable to skeptical worries along the lines of the popular suggestion that 'business ethics' is an oxymoron. I close with a brief discussion of implications and directions for future research.

1. THE MARKET FAILURES APPROACH

What is distinctive about the market failures approach to business ethics is that, in deriving the content of managers' moral duties that go beyond compliance with the law, it applies the same conceptual tools as are commonly used to justify the (government-) regulation of markets. The idea is, very roughly, that managers have a legal and moral obligation to comply with the laws and regulations that do exist, and a (merely) moral obligation to comply with laws and regulations that *should* exist. This formulation is too rough, for the question whether a law should exist is complex and an important factor is what the costs would be of having a particular law in a particular context. However, for the moment, this rough characterization will suffice. Moreover, it helps to draw attention to an important feature of the market failures approach. For the question of which laws and regulations should exist, is a question that falls into the realm of political, rather than moral, philosophy.

Political philosophers, at least those working broadly within the liberal tradition, accept that the role of the state is not to promote the moral truth or the good life, but to provide a framework in which people can peacefully coexist and interact despite their deep disagreements about at least some moral questions. Since modern commerce takes place in (at least) as diverse an arena as modern politics, it would seem desirable to have a system of ethics regulating business activities that is equally neutral between competing moral outlooks. Such an approach to business ethics would, among other things, promise to provide an ethical framework for commerce that is acceptable to people with a wide variety of ethical commitments (cf. Rawls, 1996: 9). At the same time, it would be a somewhat minimal approach, in that it would answer only a limited range of questions. It would not answer questions of the kind 'how should I behave in business *given that I am a* ... [fill in religious/moral affiliation here]? The point of such an approach to business ethics would have to be to develop some guidelines that are (as far as possible) independent of particular moral views, and instead are derived from what is necessary to ensure that the shared arena of commerce functions smoothly in a way that allows every participant to pursue their own goals.

Thus, the market failures approach integrates business ethics into the larger project of figuring out how to best organize economic activity in a given society. Indeed, defenders of the approach have touted this integration as one of its main advantages. Other approaches (such as the stakeholder paradigm, corporate social responsibility, and corporate citizenship), they complain, leave a curious disconnect between

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arguments about (a) what the basic economic structures in society should be like (b) what kind of laws are best suited to erect and uphold these structures and (c) what kind of things we should expect from 'ethical' economic actors (Heath, Moriarty, & Norman, 2010: 428–30). The result, they say, is that these other approaches tend to answer (c) with something akin to a wish list of things that it would be nice for corporate managers to do (Norman, 2011: 47). Surely, however, there is a difference between things that it would be nice to do and things one is morally obliged to do. One of the main attractions of the market failures approach is that it does not blur this distinction (as other approaches tend to do).

According to the market failures approach, we can derive the content of beyond-compliance obligations by figuring out what kind of regulatory laws there *should* be (again, this is not to be taken too literally[3]). Heath provides a good illustration of how this works (Heath, 2006: 547–52). He starts by arguing that there is a good case to be made for organizing economic activity in the way we do—namely by setting up a legal system (including, crucially, a property rights regime) that allows for the emergence and maintenance of competitive markets for most goods and services. Within these markets individuals are allowed to single-mindedly pursue their own self-interest (and, by extension, corporations are allowed to maximize profits (MacDonald, 2014)). The best argument for doing things this way, Heath argues, is that it is comparatively efficient. Indeed, as Arrow and Debreu have famously shown, under a certain set of idealizing assumptions such an arrangement would never fail to to result in Pareto-efficient outcomes (Arrow & Debreu, 1954). That is to say that such idealized markets distribute economic goods in such a way that it would be impossible to improve anyone's standing without making at least one person worse-off. And while these ideal conditions never apply in the real world, it is widely agreed that even imperfect markets do, by and large, a better job at achieving efficient results than any other economic arrangement that has been tried out on a large scale (McMahon, 2013: 2–12).

Taking this argument for a market economy as a starting point, however, directly leads to a rationale for the regulation of markets, i.e. boundaries to the ways in which individuals may pursue their self-interest (or in which corporations may maximize profits). As Arrow points out, the argument for profit maximization breaks down in those situations in which markets fail to deliver efficient results (Arrow, 1973). Situations like that are what economists call 'market failures'. Prominent examples for conditions causing market failure include asymmetric information, market power, and the presence of externalities. Market failures are very commonly the starting point for the justification of regulatory laws (see, e.g., Norman, 2011: 51; Spitzer, 2011: 22–9). And that is, of course, quite appropriate. If the point of having a market in the first place is to achieve Pareto-efficient outcomes, then there can be no objection to laws that curb the pursuit of self-interest in order to correct for the market's failure to do so (supposing, of course, that these laws are not only well-intentioned in this way, but also well-crafted so as to actually achieve their purpose).

But the law is a blunt instrument and regulatory bodies are often slow to react to new developments. For these reasons it is inevitable, in any even modestly complex real-world market economy, that there are market failures that are not being corrected

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for by efficiency-improving regulation. And it is these uncorrected market failures that provide the need for business ethics. On this picture, business ethics consists mainly of what Christopher McMahon calls *efficiency imperatives*, i.e. “hypothetical imperatives which are generated by economic theory when the achievement of economic efficiency is taken as an end.” (McMahon, 1981: 255) As Heath puts it: “the ethical firm does not seek to profit from market failure.” (Heath, 2006: 550) That is not simply because profiting from market failure would be a nasty thing to do (Heath, 2014: 10). Rather, profiting from market failure is incompatible with the point of having a market economy in the first place. That is why there is a straightforward sense in which a law against it could be justified; and that, in turn, is why it is unethical to do it even in the absence of such laws.

In the next section, I will turn to the question of how this line of thinking can come to generate restrictions on what, in particular, corporate managers may (ethically) do. But before I move on to this task let me close this section with two comments on the market failures approach as sketched so far. First, note that the approach can potentially give an account of what exactly is wrong with many business practices that a lot of people find objectionable, and at the same time account for the competitive nature of markets. Many of these practices undermine the so-called *Pareto-conditions* for the efficiency of markets, i.e. the conditions under which markets deliver Pareto-efficient outcomes. The extraction of monopoly rents, for example, is wrong on this picture because the abuse of market power militates against the efficiency of the market (rather than because the pursuit of profit is inherently bad, or because consumers are being ripped off). Excessive pollution should be avoided because it imposes uncompensated costs on unwilling parties, and is thus a classic example of a negative economic externality. Similarly, misleading advertising exploits and exacerbates existing information asymmetries (Heath, 2006: 551). The sale of unsafe products to unwitting customers combines those two vices.

However, as Heath has recognized, his early slogan ‘don’t seek to profit from market failure’ was somewhat misleading (Heath, 2014: 5–9, 199–203). As Norman points out, not all strategies that involve profiting from market failure are incompatible with a commitment to an efficient market. Some market failures are deliberately created in order to combat the bad effects of others. For example, when there is a threat of insufficient investments into the development of new products where such development is costly, we allow (and even ensure) that innovators gain temporary monopoly status so that they can try to recover their development costs through monopoly rents (Norman, 2011: 52–3). While this argument is arguably often abused by innovators clamouring for stricter protections of intellectual property rights, it is certainly sound in principle. Moreover, there are situations in which profiting from unregulated market failure is exactly the first step in correcting it. That is the case, for example, when a new business takes advantage of inflated prices for a product that are due to insufficient competition in the industry. The new business can gain market share by offering its products for a price that is closer to the efficiency price thereby shaking up the industry and moving it away from (quasi-) oligopoly towards more perfect competition. Thus, the slogan ‘don’t profit from market failure’ needs refinement.

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I will not attempt to provide such refinement here.[4] But the need for it explains why some who have proposed amendments to Heath's view prefer to talk about the "self-regulation approach" (Norman, 2011). The 'market failures' label may seem to suggest that, morally speaking, all market failures must not be exploited and this is all that matters. But, as we have seen, in some cases the exploitation of market failures is unproblematic (and should be seen as such by the account's lights). Elsewhere, Heath has referred to the approach as 'Paretian' (Heath, 2013). As he admits, this might be a more accurate label than 'market failures approach' (Heath, 2014: 5–12). It captures nicely the fundamental idea at the heart of his view, namely that the central role Pareto-efficiency plays in arguing for a market economy in the first place should be seen as implying a similarly (if not equally) central role for Pareto-efficiency in business ethics.[5]

2. MANAGERS AS PROFESSIONALS

Proponents of the market failures approach think of business ethics as a branch of professional ethics. As Heath puts it: "business ethics is concerned with the special obligations that arise out of the managerial role, and which are imposed upon the manager *qua* manager." (Heath, 2006: 534; Brown, 2013: 490–8). The idea is that just as doctors and lawyers have moral obligations that arise out of their role as professionals (and thus are obligations they have *qua* doctor or lawyer), so managers too have obligations that arise out of their professional role and accrue to them *qua* manager (rather than *qua* individual or person) (Brown, 2013: 498–9; Heath, 2006: 534–7). This is not a particularly revolutionary thought. Both of the traditionally dominant paradigms in business ethics—the shareholder model and the stakeholder model[6]—are probably also best understood as formulating a kind of professional code of ethics for managers (Heath, 2006: 534).[7]

In this section, I will show that this commitment to managerial professionalism generates a problem for the market failures approach. What is special about professional ethics is that the obligations people have in virtue of occupying a professional role are generated by the specific demands of that role and the institutional setting in which that role is embedded. However, as we will see, the most plausible analysis of the managerial role does not generate a professional ethics code that includes the obligations to curb the pursuit of self-interest in the way that the market failures approach prescribes.

The claim that managers are professionals, "(or at least relevantly akin to) *professionals*" (Brown, 2013: 490), is far from obvious. Managers do not generally form professional associations as lawyers and doctors do. It takes some work, therefore, to explain why they should nevertheless be thought of as professionals. Thomas Donaldson has attempted to do that work. According to his definition a professional "is someone who professes skills and knowledge derived from an ongoing institution dedicated to a broader good that defines both expertise and service." (Donaldson, 2000: 87) Let us grant the part about skills and knowledge (although it is anything but clear that there is an 'ongoing institution' through which managers acquire them). What is more interesting in our context is in what sense managers are or ought to

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be committed to a 'broader good' and what that broader good is. Donaldson posits, rather uncontroversially, that a good manager is a manager who competently pursues and reaches the ends of their corporation. He then goes on, however, to say that properly understood the ends of a corporation include stakeholder interests or general public welfare (Donaldson, 2000: 89). This is a highly controversial claim and it must not simply be assumed as part of an analysis of professionalism.[8]

The problem with Donaldson's claim regarding the ends of a corporation is that he seems to confuse the aim of a corporation with the aim of *having corporations around*. The latter is quite plausibly thought of along the lines of enhancing public welfare; the former, however, should be more narrowly construed as competing in the market successfully. This is because, if the point of having a market economy involving corporations is to enhance public welfare by exploiting the efficiency of a competitive system, then the players in this system have to actually behave competitively in order to make the system work. An analogy might be helpful here. Imagine you are setting up a soccer tournament with the goal of providing entertainment for the spectators. This scheme will only work, of course, if the players are actually trying to win, rather than trying to entertain. The goal of setting up a competition is different from the goals that competitors have; and typically the competition will work only if that is so.

Eric Brown's analysis of managerial professionalism sensibly departs from Donaldson's in that he does not rely on the dubious claim that the aims of a private business corporation include a concern for public welfare. He begins by observing that managers operate within two different (though related) institutional contexts: the firm and the market. Omitting a discussion of the former, he suggests that managers as agents within a market setting are implicitly committed to the aims of the market. And the aim of the market, according to Brown, is efficiency (Brown, 2013: 499–500). This is a more promising account, for it does not confuse the aim of competitors with the point of having a competition. And once we grant that managers fulfil the 'serving a broader good' clause in virtue of being committed to the efficiency of the market, it is easy to see how prohibitions against exploiting and exacerbating market failures figure into their professional ethics code. Ultimately, however, this will not do. The reason is that Brown, while recognizing the difference between the aims of the corporation and the point of market competition, does not take it seriously enough.

Managers, after all, see their role as helping the corporation to achieve its aims, rather than as helping to maintain a competition that promotes efficiency. Thus, the idea that managers are professionals because they are (or ought to be) committed to the efficiency of the market would come as a surprise to most actual managers. In William Baumol's words, "[an economist] is more concerned than the individual executive is likely to be about the total performance of the system." (Baumol, 1974: 59) And this is, of course, as it should be. Managers need to be concerned with the performance of their own corporation, if market competition is to actually work. Having corporate managers adopt the economist's perspective instead and concern themselves with the 'performance of the system' would be self-defeating. It would be akin to soccer players aiming directly at good entertainment and thereby, most

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likely, ending up providing a less entertaining game. Blurring this difference in perspective is a shortcoming that Brown's analysis shares with Donaldson's (and, as we will see below, with Heath's). Both of them posit a broader good that managers are (or ought to be) committed to: Donaldson because he thinks that the goal of a corporation includes a concern for public welfare; Brown, because he thinks that operating within a market setting comes with an implicit commitment to the goal of the market. But managers will not and should not take the broader perspective (represented by Baumol's economist) and thus will not share this view. Therefore, according to both Donaldson's and Brown's accounts of professionalism, managers are not professionals.

The problem lies in the fact that both authors are looking for something too lofty to fulfil the 'commitment to a broader good clause' of professionalism. It is worth noting that, in his first formulation of this clause, Donaldson merely speaks of "a good broader than self-interest" (Donaldson, 2000: 87). That is not a very high standard; and there *is* a good broader than (managerial) self-interest that managers are committed to in virtue of their role, namely the good of the company (which in many cases will be construed as shareholder value). This leaves us with a dilemma. It seems that we will either have to accept that managers are not professionals, or that they are professionals but only in virtue of being committed to advancing the interests of their own corporation. Either way it does not seem like prohibitions against exploiting market failures will apply to managers under this analysis of professionalism.

Heath offers his own analysis of professionalism, which is different from, and in some ways more illuminating than, Donaldson's. But, as I will show, ultimately it too lands us on the second horn of the dilemma just described. To the question in what sense managers are relevantly like professionals in the absence of many of the conventional marks of a profession, Heath replies that it is "[t]he fact that they are in a position of trust that matters" (Heath, 2006: 537). His analysis begins with the observation that information asymmetries can make it hard to organize mutually beneficial transactions. If a significant information asymmetry between the buyer and the seller of a product or service cannot be overcome, and if the party with less information has reason to believe that the other party will behave opportunistically, they will walk away from the transaction leading to a lost opportunity for both parties (cf. Akerlof, 1970; Williamson, 1981). Information asymmetries of this kind abound, but in many cases there are mechanisms to alleviate their bad effects. In the case of transactions that many people will engage in repeatedly, for example, reputation effects can help to both alleviate the information asymmetries and reduce the incentive to behave opportunistically. The need for professions arises in situations where such "natural" solutions are not available. That might be the case, for example, because performance is hard to judge even after the transaction is completed. For example, even after you know the outcome of your court case, you would still need significant legal expertise to judge your lawyer's performance (whereas if your brakes fail a week after your mechanic fixed them, you can be pretty sure he did a shoddy job). Or because the service in question is so infrequently provided that there is no sufficient sample size for reputation effects to kick in (how many people do you know who can confidently recommend their heart surgeon?).

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The point of professionalization, according to Heath, is to overcome these problems. It achieves this not by alleviating the information asymmetry (the asymmetry remains, that is why a common body of specialized knowledge is often thought of as a distinguishing mark of professions) (e.g. Goldman, 1992), but by establishing mechanisms designed to ensure that their members are trustworthy, i.e. do not behave opportunistically. Thus, the main function of a medical licensing board is not to reduce the information asymmetries between its doctors and their patients, so as to empower the patients to provide more efficient oversight of their doctors. Rather, the licensing board itself does the overseeing on behalf of the patients, using the expertise of its members to do so.[9] In addition to such formal oversight mechanisms, professions rely on a large range of methods of professional enculturation. Beginning in medical school, for example, aspiring MDs are constantly being reminded that to be a doctor comes with great responsibilities that go beyond acquiring specialized skills and knowledge. According to Heath, professional ethics codes serve that same function: being bound by a code that prohibits opportunistic behaviour is one way in which a professional can overcome the problem of trust in situations in which the problem of information asymmetries cannot be resolved.

Just like Donaldson's, this analysis provides a general picture of what is involved in being a professional that is in principle applicable to fields that are not widely recognized as populated by professionals. In contrast to Donaldson, however, who focuses on what professionals are like (explicitly requiring commitment to a broader good), Heath focuses on the circumstances in which we need certain positions to be filled by professionals, i.e. people we can trust even though we do not fully understand what they do. The next step is to show that managers occupy such positions. This in itself is not a difficult task. It has long been recognized, often under the heading of agency theory that managers as agents of the firm are in a position where only limited supervision and evaluation is possible. That is why it is commonly acknowledged that managers have fiduciary duties towards the firm (Marcoux, 2003: 12–4). Stakeholder and shareholder theorists argue about whether these duties to 'the firm' should be understood as duties towards the firm's shareholders, or towards the firm as such, construed as an entity independent of the people who happen to own its shares or, more generally, are its residual claimants.[10]

Under the analysis of professionalism currently under consideration, it is easy to see how shareholder theorists can claim that managers are (quasi-) professionals. There clearly are important information asymmetries between managers and shareholders that can have an impact on the economic interests of the shareholders. And these information asymmetries cannot be significantly reduced, partly because one of the very points of separating ownership and control is to allow people to invest capital in businesses that they are not all that knowledgeable about. This information asymmetry, in turn, creates a moral hazard problem that needs to be combated by the attribution of fiduciary duties on the part of managers towards shareholders. It is difficult to see where one could find an analogous information asymmetry between managers and "the firm", and so, under Heath's analysis, professional obligation has less of a role to play vis-à-vis the firm construed as an independent entity. Stakeholder theorists who take a multi-fiduciary perspective will point out that there are

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also important information asymmetries between managers and non-shareholding stakeholder groups. The degree to which the information asymmetries between managers and shareholders are more severe and less avoidable than between managers and other stakeholder groups is subject to debate.[11] For current purposes, however, we can ignore this question and follow Heath who is most impressed by the information asymmetries between managers and shareholders.

Heath himself states that his analysis of professionalism naturally leads to the conclusion that managers have fiduciary duties towards shareholders (for roughly the reasons just rehearsed). However, he says, the fiduciary duty to further the shareholders' economic interests is subject to side constraints (Nozick, 1974). And it is in generating a set of side constraints specific to the business context that the market failures approach becomes germane (Heath, 2006: 551).

> [Shareholder] primacy is preserved, in the sense that if there is a conflict between the *interests* of various constituency groups, management should assign priority to the interest of shareholders. If, however, the conflict is one between the interests of shareholders and the principle that managers should refrain from taking advantage of market power [among other ways of exploiting market failures] in dealing with other constituencies, then the principle trumps the interests. (Heath, 2011: 19)

While I think that this view (a version of 'tinged shareholder theory' (Langtry, 1994)) is compelling, it is unclear how these side constraints can be motivated as part of a professional code built on the notion of professionalism as overcoming a problem of trust. After all, the side constraints that the market failures approach will generate are going to be geared towards the public interest (in an efficient market). To be sure, the public is affected by the actions of corporate managers and there will be considerable information asymmetries between them and any member of the public, but as I said above, it is not very promising to construe managers in private corporations as, essentially, agents of the public interest. And without that there is no reason to overcome these information asymmetries; and thus there are no grounds for professional duties.[12] This means that the (plausible) view that Heath outlines in the passage just quoted cannot be generated by his own analysis of the (quasi-) professionalism of corporate managers. Thus, it is unclear how, on Heath's view the 'principle [that] trumps the interests' can find its way into the professional ethics code.

3. SHAREHOLDERS AND THE NEMO DAT PRINCIPLE

The duty to avoid improper exploitation of market failures does not originate in the professional role of the manager in the same way that fiduciary duties towards shareholders (or other residual claimants) do. But then, where do they come from and why do they apply to managers? The answer, I think, is simply that these are duties that shareholders have and managers, as their agents, inherit them.[13]

Now the second part of this claim is easily defended. If shareholders have a duty to abstain from certain forms of exploiting market failures, then there can be no serious objection to the claim that managers inherit these obligations. This is what

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Kenneth Goodpaster has termed the Nemo Dat Principle (NDP): "I cannot (ethically) *hire* done on my behalf what I would not (ethically) *do* myself." (Goodpaster, 1991: 68; cf. Locke, 1960: §135). This is a very compelling and widely accepted principle, and rejecting it would open glaring moral loopholes (Pogge, 1992). There are exceptions to the NDP but they usually have to do with special qualifications on the part of the agent that ensure that no third parties are negatively affected (e.g., you may not handle certain toxic chemicals yourself, but you may hire an expert to do it on your behalf). And while managers will often have qualifications that investors lack, these are not generally qualifications necessary to avoid harm to third parties. It is safe to conclude, then, that if shareholders have a duty to self-regulate, then this duty applies *ipso facto* to managers also.

But do these self-regulatory duties really fall on the shareholders? It may be worth noting that, if such a duty fell on managers but not on shareholders, this would have the curious consequence that shareholders could not (ethically) hire someone to do what they themselves could (ethically) do. They themselves would not be subject to the prohibitions implied by the market failures approach but the managers they hire to look after their interests would be. This reversal of the *nemo dat* principle is not very plausible. That I cannot hire someone to do something that I am permitted to do would mean that the permission comes attached with a duty to do it myself. We might think that certain permissions regarding one's personal affairs (such as committing suicide or, less dramatically, telling my wife that I no longer love her) have that structure. But these are either cases in which nobody, apart from the person herself, is harmed, or cases in which permissible harm would be amplified to an impermissible level (or kind) through bringing in an agent. There is no reason to think that profiting from market failure would fall into either of those categories.

But even apart from those considerations, it makes sense that it is with shareholders that prohibitions against improper exploitation of market failures originate. It is them who are ultimately engaged in the pursuit of self-interest that the market is supposed to transform into an efficient outcome, which is desirable from a public policy point of view. Thus it is them, rather than the agents they hire, who have an obligation to pursue their own self-interest only in ways that are compatible with the efficient functioning of markets. The underlying principle here is the following. Assuming that a given institutional setting is just (or at least justifiable), agents within it ought to act in ways that are compatible with the justification for the institutional setting. Thus, investors who compete in the market (for, among other things, the services of capable managers) ought to do so in ways that are compatible with the justification for having a market. The way to do that is to resist the temptation to exploit market failures or, more generally, imperfect regulation. This is why the market failures approach is best understood as applying to them. By the same token, managers, insofar as they are agents hired by shareholders to look after their economic interests, ought to do so in ways that do not undermine the justification for the division of ownership and control. The best way to do that is to reduce agency costs by being a loyal fiduciary and resisting the temptation to exploit moral hazard (Buchanan, 1996).

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I conclude that we should conceive of (ethical) managers as the loyal agents of shareholders who are ethically prohibited from engaging in behaviour that undermines the tendency of the market to produce efficient results. Assuming the validity of the *Nemo Dat* Principle in this context, I further conclude that managers inherit the duties of their employers and are thus subject to the same prohibitions. A loyal agent ought to serve his principal's interest *while respecting the moral obligations that the principal is under*. Thus, the source of managerial duties to abstain from efficiency-undermining exploitation of market failures is the very same agency relationship that is also the source of managerial duties to serve shareholder interests. This analysis is preferable to one in which managers are subject to conflicting ethical demands from two different ethical codes both supposedly grounded in their economic role. Another significant advantage of embedding the market failures approach within the ethics of agency relations is that managers already understand and generally accept (even if they do not always adhere to) agency ethics. Practically speaking, there does not seem to be much promise in opposing the "widespread normative consensus that corporate managers should act exclusively in the economic interests of shareholders." (Hansmann & Kraakman, 2000) Instead, the market failures approach should be understood as insisting on the amendment that managers should pursue the *legitimate* economic interests of shareholders and as offering an account of what this proviso comes to.[14]

4. TWO WORRIES ABOUT PRACTICABILITY

Before I conclude, let me defend the version of the market failures approach that I have developed so far against the charge that it is *impracticable*. We may call a theory of business ethics impracticable, if businesspeople could not follow its prescriptions.[15] For example, it is a common charge against the stakeholder paradigm that it is hard to square with the market as a competitive arena (Goodpaster, 1991; Marcoux, 2003). We need not concern ourselves here with the question whether stakeholder theorists can answer this charge, but only note that it is a serious challenge threatening the paradigm's status as a viable contender as a theory of businesses ethics. While it certainly is worth debating the merits of alternative economic arrangements, a theory of business ethics that has any hope of providing guidance to managers within our current system simply needs to take competitive markets (and some measure of justification for them) for granted (Heath, 2006: 552).

There are two features of the market failures approach as developed in this paper that may raise red flags with regards to the criterion of impracticability. The first one is specific to my version of the approach as specifying duties of shareholders that are passed on to managers. One might worry that to burden potential shareholders with such duties is to burden them with duties the fulfillment of which would require more expertise than we can expect the general public to have. Since it is a desirable feature of our current economic arrangements that shares can be owned by members of the general public without much economic expertise, the objection continues, the account is impracticable. It makes it impossible for most members of the public to invest in companies without morally compromising themselves.

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But this charge underestimates the power of the division of labour. Just as shareholders can hire agents to look after their economic interests, even though they do not really understand how exactly managers accomplish that, so too can they rely on these agents to see to it that they are not morally compromised. In fact, such reliance seems inevitable. Whenever I hire somebody else to do something for me that I cannot do myself, I expect that this person does not do anything in my name that I have an obligation to abstain from.

It might be replied that shareholders do not care about their duties to abstain from improper exploitation of market failures. We need to distinguish two senses in which that might be true. One is that shareholders do not pay enough attention to business ethics to know that their duties as players in a competitive market include duties of this kind. In that case, shareholders may care deeply about not being morally compromised by managers who do what is wrong in the shareholders' name; it is just that they may not know what constitutes wrongdoing in this context. This might be true, but it is not a problem of impracticability. Instead, it is just another version of the original worry that shareholders do not understand what their duties are. This worry has already been answered. Moreover, it is likely that the market failures approach is quite capable of generating a list of duties that shareholders will recognize—even if they are unlikely to think much about the theoretical underpinnings of such a list.[16]

The other possibility is that shareholders just do not care about whether what is done in their name is immoral as long as they are making money. This might be true of some shareholders but it is unlikely to be true of all or even most shareholders.[17] Managers will, of course, be tempted to defend unethical business practices by pointing to shareholder value. But if the account given here is correct, this simply amounts to the managers claiming that their shareholders—their principals—do not care about being morally compromised. In other words, such a defence assumes that the managers see themselves as having been hired to "make a profit no matter what it takes". This is not the way that executive contracts or corporate charters are usually phrased (in fact very few corporate charters make explicit mention of profit maximization at all). Absent explicit orders to disregard moral obligations, it seems obvious that managers ought to assume that they are hired, to paraphrase none other than Milton Friedman, to make a profit while abiding by the prescriptions of both law and morality (Friedman, 1970). When management claims that it has to engage in unethical behaviour in order to remain loyal to shareholders, it essentially claims that its shareholders are crooks with no regard for morality. I venture that most of the time this will be false. When it is true, it seems to be a moral reason to quit, rather than a reason to do the crooked shareholders' dirty work.

But this leads to another way in which the objection may be presented. Would managers who abstain from profitable but unethical practices not risk their jobs, if they did not make as much profit as possible? Again, the answer is twofold. If shareholders do in fact have no moral qualms whatsoever, then they might fire such managers; in that case managers should be glad to leave rather than having to continue to work for an employer like that. This would be problematic if it were the case that most shareholders are of that type. But the threat to be fired over less than

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maximal profits is all too easily overstated. Boards will often be quite receptive to managers who explain that their less-than-exemplary profits are partly a result of a conscious choice that "we don't want to be that kind of company".[18] In this context it is worth noting that defences against hostile takeovers have typically been upheld by the courts (Marens & Wicks, 1999: 281–3). This shows that senior management is not simply at the mercy of the market for corporate control. Moreover, the bad reputation of hostile takeovers (which partly explains the legal successes against them) can be nicely explained within the current framework; for the stereotypical callous corporate raider (think Gordon Gecko) is exactly the kind of shareholder that does not care about violating moral constraints as long as it is profitable to do so.

A second worry about practicability concerns the market failures approach as such—independent of whether I am right that the duties it generates lie in the first instance with shareholders. The worry is that, unless everyone in the market abstains from efficiency-undermining exploitation of market failures, the ethical companies that do are going to be pushed out of the market by their less scrupulous competitors. This is a valid concern (Heath, 2014: 202). The market failures approach asks businesses to abstain from some profitable practices.[19] If competitors are not abstaining from these practices, they have an obvious advantage. I think the response to this worry must be two- pronged. First, 'everyone else does it' can only be an excuse but never a permission to engage in unethical practices.[20] Moreover, in the current context this excuse can be valid only if the pressure created by competitors' engaging in such practices is quite high, so as to seriously undermine the viability of one's enterprise. I seriously doubt that competitive pressures meet that standard in most industries.

Secondly, however, using the 'everyone else does it excuse' is credible and admissible only when combined with an attitude towards industry-wide (government) regulation that Baumol has termed *meta-voluntarism* (Baumol, 1974: 70). When a company cannot afford to do the right thing, because doing so would put it at a serious competitive disadvantage vis-a-vis other firms in the industry, it may be excused for doing what they need to survive for the time being. But it ought to attempt to change the situation. This could be done by developing industry-wide standards in cooperation with the main competitors.[21] If that fails, the firm ought to alert the government to the fact that the competitive situation in the industry provides perverse incentives of this kind. Or, at the very least, it ought not to lobby against effective regulation (Baumol, 1974: 61; Heath, 2004: 84).

CONCLUSION

I have argued that the market failures approach to business ethics is best understood as providing a minimal standard of ethical behaviour when seeking one's self-interest in competitive markets. Applied to the setting of publicly held companies, this means that the duties it generates fall in the first instance on shareholders. But that does not mean that corporate managers are off the ethical hook. Their professional role entails duties of loyalty towards shareholders, as is widely accepted by scholars of corporate law and by managers themselves. As loyal agents, managers inherit the

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obligations that shareholders would have to heed, if they were to act on their own behalf. This is how the duties generated by the market failures approach come to be constraints on the ways in which managers can pursue profits.

This result has a number of implications worth making explicit. First, the arguments in this paper point towards interesting questions regarding the ethics of investing in the stock-market. I have argued that, generally speaking, investors have to rely on those acting on their behalf to see to it that they are not unwittingly morally compromised. This raises the question, however, as to how much vigilance is ethically required from such investors in monitoring those acting on their behalf. It also raises questions about what investors ought to do, when it becomes clear that executives are behaving in ways that do in fact morally compromise them (the investors). These are questions for future research.

Second, with regard to managers who behave in ways that undermine the Pareto-efficiency of the market, my view makes available a more decisive moral criticism than the market failures approach as usually conceived. On the view espoused by Heath and by Brown, the following defense is available for managers who behave in ways that undermine the efficiency of the market: "well, as a manager I'm subject to two special codes of ethics—one having to do with the Pareto-efficiency of the market, and one having to do with loyalty to my employer. If they conflict, I need to go one way or the other, and this time I went with loyalty." It is not obvious how this could be criticised from the vantage point of Heath's version of the market failures approach. After all, conflicting obligations are a real pickle in our moral lives, leading to tragic situations in which an agent has to make a choice between alternatives every one of which will lead to a violated obligation (Williams, 1981: 74–8). In such situations it may seem unfair to criticize the agent for violating an obligation. By contrast on the picture that I have argued for, there can be no conflict between the obligations of loyalty and the obligations generated by the market failures approach. Observing the latter is part and parcel of observing the former. A manager who violates the duty not to undermine the market thereby morally compromises his or her employer. And this in turn amounts to a violation of the duty of loyalty (as opposed to being justified by it).

Finally, many students attend business school with the aim of becoming corporate executives. Insofar as we are thinking of such executives as professionals, we should expect business schools to play their part by shaping students to graduate with a professional mindset. If the argument presented in this paper succeeds, this means that business school curricula should emphasize that thinking of managers as agents with fiduciary duties entails that they are stewards of their employers' moral as well as economic interests. Thus, business ethics should not be taught as a potential impediment to the fulfillment of a manager's duties of loyalty, but as a part of it. This stance is to some degree independent of the context of the market failures approach—it is justified as long as one follows Goodpaster in locating the ultimate source of managers' duties in their employers. But thinking about employers' duties in terms of the market failures approach should help. For by showing how these duties are derived from thoroughly market-friendly considerations, we can disarm the suspicion (not uncommon amongst business school students and faculty) that business ethics is "implicitly, if not explicitly, anticapitalist." (Heath, 2014: 91).

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NOTES

1. Heath has also called his approach the *Paretian Approach* (2013 and 2014), and Wayne Norman has defended what he calls a 'friendly amendment' to the approach under the label *Self-Regulation Approach*.

2. My focus on the obligations of corporate managers is in keeping with much of the business ethics literature in general and the proponents of the market failures approach in particular (cf. McMahon, 2013: 11).

3. For a discussion of the various possible reasons for the absence of ceteris paribus desirable regulatory laws (see Norman, 2011: 53–54).

4. For some tentative steps in that direction (cf. Heath, 2004, 2007; Norman, 2011; Brown, 2013).

5. Against this Norman points out that there can be legitimate reasons to regulate the market apart from efficiency considerations. It is not quite clear whether such reasons should then also carry over into the beyond compliance realm (i.e. business ethics). 'Self-regulation' is neutral in that regard. It simply connotes the idea that businesses ought to follow those regulations that would be enacted, if regulators were able get things right.

This leads me to another comment. One might think that the market failures approach gives moral license to businesses to disregard poor (i.e. efficiency undermining) regulation (cf. Jaworski, 2013a, 2013b). I do not think that this is the case. The market failures approach may not itself offer a rationale for complying with bad regulatory laws. But that is one thing; to say that the approach licenses disobedience to such laws is quite another. There are good reasons to obey bad laws as long as they are legitimate and not egregiously unjust. These reasons are not provided by the market failures approach; but they are surely compatible with it (cf. Heath, 2013: 55).

6. For classic statements of these paradigms (cf. Friedman, 1970; Freeman/Reed, 1983; Freeman, 1984).

7. Roughly put there are two kinds of considerations that motivate the adoption of a professional ethics framework. First, the kind of rules that the market failures approach recommends differs from the rules of ordinary morality. Most importantly, because of the adversarial nature of the market, the market failures approach recommends a weakening of the general moral requirement to engage in altruistic behaviour. But there are also arguably some ways in which the commitment to an efficient market generates obligations that go beyond what is required by everyday morality. McMahon argues, for example, that what he calls "the implicit morality of the market" requires an extraordinary willingness to share information that goes far beyond the candor morally required in everyday life (McMahon, 1981: 256–258). Second, a professional code that is, as Heath puts it, "*already implicit* both in the structure of corporate law and in the best practices of working managers" (Heath, 2006: 534) is more likely to gain motivational traction with actual managers. If business ethics is to be taken seriously by managers, goes the thought, it had better take seriously the special demands that come with that job.

8. On the dangers of such blurring of the distinction between corporate managers and public servants (cf. Goodpaster, 1991).

9. For an analysis of the structure of obligations that are generated in this way (see MacDonald (1999)).

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10. For some notable contributions to this debate (see Easterbrook/Fischel (1989); (1991); Clarkson (1998: 1); Bowie (1999:144); Blair (1999); Greenfield (2006)).

11. For clear overstatements (see Macey (1991); Marcoux (2003). For more measured perspectives see Stone (1991); Blair (1999); Brown (2013); von Kriegstein (2015)).

12. To see that one party affecting the other is not by itself enough to warrant concern with the information asymmetry, consider that a defendant will be impacted by the actions of the crown's lawyers and that there will be a significant information asymmetry between them. But, because the crown's lawyers are not acting on behalf of the defendant, there is no need to remedy this situation.

13. Alternatively, one may give up on the idea of professionalism and simply claim that the duties generated by the market failures approach simply apply to everyone engaged in market transactions.

14. It is worth noting, at this point, that this section has proceeded on a set of controversial assumptions about the relationship between a corporation and its shareholders (or, more generally, residual claimants). In particular, one may contend that it is the corporation itself, which is pursuing its economic self-interest in the market and which is also the party that managers owe fiduciary duties to. In the background here looms the question whether we should think of a corporation as an entity separate from the individuals who are engaged with it or as a mere legal fiction (i.e. a *nexus of contracts*). I do not mean to take a stance on this question in this paper. I have here assumed the nexus of contracts view for the sake of argument. It requires some effort to show that it is plausible that the obligations of the market failures approach could fall on shareholders (which is the task of this and the following section). By contrast, if one adopted the view that managers owe their duties to the corporation, construed as a separate entity, the task would be considerably easier. On this picture the obligations of the market failures approach would directly fall on corporations and would then be passed down to the managers who act on behalf of them.

15. This is to be differentiated from the common complaint that about (the entire field of) business ethics is that it is 'unrealistic'. Insofar as the charge is simply intended to express the sentiment that self-interest reigns supreme in the context of business, it is not an objection that needs to be taken seriously. This sentiment typically rests on some confused variation of psychological egoism, where the 'selfishness of managers' and the 'greed of corporations' are being presented as ineliminable facts of nature. Even if the objection were cleaned up to include only one of those incompatible supposed facts (on the incompatibility of the selfishness of managers with the profit maximization of corporations cf. Michalos, 1995: 47–50), there are two very good reasons to disregard it. First, it is simply not true that managers always behave selfishly nor that they always pursue profits without any regard for the wider consequences. Second, even if they did, we should take that as a sign that they are behaving unethically, not as a sign that business ethics is 'unrealistic'.

16. For lists of (somewhat) concrete duties (see Brown, 2013: 490; Heath, 2004: 84).

17. For a more pessimistic assessment (of sorts) (see Wesley/Ndofor (2013)); their results suggest that equity markets are indifferent even to known ethics violations.

18. For a classic, if perhaps disingenuous, example of management convincing shareholders to reject a takeover bid on moral grounds (see John Gutfreund's arguments to the board of Solomon brothers as outlined in Lewis, 1989: 198–202).

19. It may be worth noting, however, that it is questionable whether any approach that does not make that demand could count as a genuine approach to business *ethics* (cf. Attas, 2004).

20. Someone who has a permission to do x is not doing anything wrong in doing x; by contrast someone who has an excuse for doing x is doing something wrong in doing x, but there are extenuating factors that would make it unfair to blame them for acting wrongly (cf. Baron, 2007: 22–3).

21. Cf. Balleisen (2010) for a somewhat optimistic, Laufer (2006) for a rather cynical review of strategies of that kind.

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