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CONFLICTS OF INTEREST:  
THE ETHICAL VIEWPOINT

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## CONFLICTS OF INTEREST: THE ETHICAL VIEWPOINT

### Abstract

Conflicts of interest are a very widespread ethical problem which, precisely for that reason, deserves special attention, both from a legal viewpoint and from the point of view of ethics applied to organizations and professions. In this paper we use the conceptual framework of agency theory to explain what constitutes a conflict of interest. This enables us to identify what causes conflicts of interest and analyze the ethical criteria to be applied to them and the solutions commonly proposed. Because our processing of information, our judgments and our decision making are subject to significant unconscious and unintended biases, the emphasis in this paper is on the conditions that an agent's decision must satisfy in a conflict of interest situation in order to be ethically correct.

**Keywords:** Agency theory, Agent, Conflict of interest, Corruption, Ethics of professions, Principal.

## CONFLICTS OF INTEREST: THE ETHICAL VIEWPOINT

### Introduction<sup>1</sup>

In recent years, conflicts of interest have started to attract much more attention from society, above all in response to various recent scandals. Examples of such conflicts are easy to find:

- A doctor advises her patient to undergo certain tests or treatments in the doctor's own clinic or one in which she has a financial interest or that belongs to a relative.
- A doctor recommends medicines manufactured by pharmaceutical companies that pay for her holidays, trips or medical equipment.
- A doctor advises a patient to take part in a research project, related to the patient's illness, for which the doctor will receive some kind of remuneration.
- A public official sits on a disciplinary committee that has to judge the behavior of a professional ally (or enemy).
- An academic evaluates articles submitted to scientific journals by professional allies (or enemies).
- A consultant recommends that the content and scope of her brief be broadened, with the result that she earns more.
- An employee advises against introducing new technologies for which she lacks the necessary training.
- A manager receives from her employer stock options whose value may be influenced by her professional conduct.
- A financial analyst issues undeservedly favorable valuations of a company's shares because the organization she works for is involved in selling those shares, or because her remuneration is linked to the performance of the investment banking department that is managing the sale.

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- A financial analyst gives a buy recommendation on securities that are part of her own portfolio or that of a relative.
- A bank helps to promote an offering of shares by a company of doubtful solvency because the share issue will enable the bank to reduce its credit risk in the company.
- A judge must decide a case that affects a company belonging to her brother.
- An employee of an auditing firm issues favorable assessments of a company's accounts that may help to ensure that the employee continues to receive work from the company or that the auditing firm wins contracts to provide other services to the company.
- A politician or public official advocates the hiring of a party colleague.
- A former minister is hired by a company that operates in an industry for which the former minister was responsible while in government.
- A politician or public official must decide the award of a contract for which one of the bidders is a relative.
- A lawyer represents two of the accused in the same criminal trial.

Conflicts of interest arise in many of the decisions that professionals, managers and employees, as well as public and private companies and organizations, have to make in the course of their normal activities. Note that not all of the situations listed above are necessarily immoral; but they all can lead to immoral action, and so are examples of conflicts of interest.

The purpose of this paper is to discuss possible solutions to the problem of conflicts of interest, especially from the point of view of business ethics. First, we review the concept of conflict of interest and its moral evaluation. Then, we look at the principal legal, ethical and practical solutions that have been advocated, ending with the conclusions.

## **Conflicts of interest**

In a broad sense, almost all human decisions involving other people give rise to conflicts of interest: for example, an employee's interest in increasing her earnings conflicts with her employer's interest in reducing the company's wage bill; and a doctor's interest in reducing her workload conflicts with her patient's interest in receiving better medical attention. But this concept is too broad and unworkable; conflict of that kind is inevitable, and all we can do is rely on the institutions and incentives that coordinate the interests of the two parties, and ultimately on the morality of their behavior<sup>2</sup>.

Strictly speaking, a conflict of interest arises in any situation in which an interest interferes, or has the potential to interfere, with a person, organization or institution's ability to act in accordance with the interest of another party, assuming that the person, organization or institution has a (legal, conventional or fiduciary) obligation to do so.

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<sup>2</sup> Cfr. Carson (1994), Moore (2001).

This definition contains the following elements<sup>3</sup>:

- A person, organization or institution (company, public service, government, NGO, etc.), which from now on we shall call the “agent”<sup>4</sup>,
- that has a legal, contractual, conventional, professional or fiduciary (and therefore ethical)<sup>5</sup> obligation or duty, or that holds a position of trust<sup>6</sup>,
- to act, as agent or trustee, in accordance with the interests of another party, which we shall call the “principal”<sup>7</sup>,
- which may be another person, organization or institution<sup>8</sup>.
- The agent has another interest, which she wishes to satisfy (or frustrate),
- which may be a personal (financial or non-financial) interest of the agent herself,
- or of another person or institution (relative, friend, religious or ethnic community, company, NGO, union, political party, etc.),
- toward which the agent has a contractual, conventional, professional or fiduciary duty<sup>9</sup>,
- and that other interest is wholly or partly incompatible (or is believed by the agent to be incompatible) with the interest of the principal<sup>10</sup>,
- so that it prevents or obstructs, or has the potential (or is thought to have the potential) to prevent or obstruct, the performance of the agent’s duty toward the principal.

This definition may seem too broad because it would include conflicts arising as a result of having more than one principal (for example, a lawyer who represents two clients on opposite sides of a legal dispute) and “role conflicts” (for example, when a doctor who is also a researcher advises a patient to take part in a research program in which the doctor is

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<sup>3</sup> The definition adopted here is based on Boatright (2000); see also Boatright (1992), Carson (1994), Davis (1982, 1993), Luebke (1987), and Margolis (1979).

<sup>4</sup> Agency theory is an appropriate framework for explaining conflicts of interest. Cfr. Boatright (1999).

<sup>5</sup> The ethical duty, although different in nature, coincides with the legal, contractual, professional, etc. duty; ethics is the moral dimension of that duty or obligation.

<sup>6</sup> Also, in an organization with explicit or implicit rules regarding the conduct expected of its members that prohibit the pursuit of unjust personal benefit. Cfr. MacCoun (2003).

<sup>7</sup> The principal need not be the customer. In an audit, for example, the agent will be the company, or rather the company’s top management, while the principal may be the shareholders, outside investors (including potential investors), the tax authorities, society in general, other auditors, etc. – in other words, those whose interests the auditors serve.

<sup>8</sup> If a self-employed professional hires her son as secretary, this does not constitute a conflict of interest, as she has no obligation to consider any other interest when hiring than her own. There would, however, be a conflict of interest if the professional belonged to a partnership or firm, because in that case she would have to take her partners’ interests into account.

<sup>9</sup> It is precisely that obligation or duty –associated with a public or private office, the exercise of a profession, or paid employment– that distinguishes a conflict of interest in the strict sense. Cfr. Bayles (1983).

<sup>10</sup> This is what differentiates a conflict of interest from cognitive conflict, in which both parties have an interest in resolving a problem that affects both.

involved and for which she is paid)<sup>11</sup>. However, given that our purpose is to discuss the legal and ethical solutions to these types of problems, it seems best to keep the definition broad.

For the same reason, we include both “potential” conflict and *de facto* conflict, which could be described as “abuse of office or position”<sup>12</sup>, and even the “apparent” conflict that arises when the agent thinks that there is a conflict, even if such conflict does not and cannot exist.

According to agency theory, a conflict of interest arises when three conditions are met<sup>13</sup>:

- 1) Divergence of pay-out: the interest of the principal is diffuse and low value, while the interest of the agent is concentrated and high value.
- 2) High information and monitoring costs for the principal.
- 3) High entry barriers, preventing competition among rival agents.

### **Moral evaluation of conflict of interest**

Attitudes toward conflicts of interest tend to vary considerably. It is often argued that because this is such a widespread and, in a sense, unavoidable problem, there is no point in worrying about its ethical dimension, particularly if it is believed that the professionals involved are the ones best equipped to deal with it. However, this tends to be a relativist attitude that is frequently refuted by the facts.

With respect to the moral evaluation of conflicts of interest, there is a general consensus that<sup>14</sup>:

- It is ethically wrong to act against the interests of the principal in a *de facto* conflict of interest. Doing so causes injustice because the agent has a moral obligation to act in accordance with the interest of the principal<sup>15</sup>.
- It is wrong to obtain an “undue” benefit, whether financial or of any other kind, through the exercise of a profession, duty or office – although what constitutes an “undue” benefit can only be established on a case-by-case basis. For example, a public official has a right to her salary, but not to additional income for actions resulting from a conflict of interest. Also, if an auditing firm delivers misleading reports that cast its client in a favorable light in order to retain that client’s business, any benefit thus obtained (retaining the client) will be improper. In both cases, the benefit is improper because it is the result of the agent’s putting her own interest before that of the principal, which is the interest that should rightly prevail.

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<sup>11</sup> Cfr. Stark (2003).

<sup>12</sup> Cfr. OECD (2003), no. 13. On the distinction between “risk” and “harm” in conflicts of interest, see McMunigal (1998).

<sup>13</sup> Cfr. Issacharoff (2003).

<sup>14</sup> Carson (1994) offers a detailed discussion of some of these points.

<sup>15</sup> Obviously, we are assuming that the interests of the principal are legitimate.

- The agent has an obligation to provide restitution and make good any harm caused.
- Unavoidable and systematic conflicts of interest are still conflicts of interest and must be treated as such. The fact that the agent is not to blame for finding herself in a conflict of interest situation does not mean that the situation has no moral consequences.
- Finding oneself in a conflict of interest situation is not in itself immoral if the agent has acted in good faith.
- It is ethically wrong to put oneself in a situation in which a conflict of interest is liable to arise, unless there are sufficiently important reasons for doing so. This rule applies even if the agent intends to resolve the conflict fairly and honestly – because it is wrong to put oneself at risk of acting immorally without sufficient justification.
- In a potential conflict of interest situation, there is therefore a scale of ethical evaluations, depending on the likelihood that the agent will act immorally, the agent's share of responsibility for finding herself in that situation, the scale of the harm that may be done, and the importance of the personal interest that conflicts with the interest of the principal.
- The agent must not only avoid any actual conflict of interest, but also the appearance of a conflict, unless there is sufficient reason, because integrity in a person's work or profession is a good that must be protected – although it is not an absolute good and therefore depends on circumstances or, as some authors contend, allows exceptions<sup>16</sup>. The agent also has a duty to preserve society's trust and respect for her company, office or profession.
- It is immoral to put pressure on a person to accept a conflict of interest because it is unjust to induce a person to do something wrong, or put her at risk of doing something wrong.
- A conflict of interest may cause harm to third parties and, therefore, be an injustice toward them. For example, if a doctor advises a patient to undergo treatment in a clinic in which the doctor has a financial interest, she may be engaging in unfair competition toward other clinics that offer the same treatment, perhaps on better terms for the patient.
- An agent involved in a conflict of interest must assume her responsibility for managing her own private interests in relation to her office, profession or job. She may not shift this responsibility onto the rules that govern the activities of the company, organization, market or profession: there is always an element of personal responsibility.
- Organizations and institutions involved in conflicts of interest must also assume their responsibility to identify and resolve such situations.

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<sup>16</sup> Cfr. Carney (1998).

The problem of conflict of interest is closely related to the problem of corruption<sup>17</sup>. Corruption can be defined as “a behavior which deviates from the formal duties of a public role because of private-regarding (personal, close family, private clique) pecuniary or status gains; or violates rules against the exercise of certain types of private-regarding influence”<sup>18</sup>. Based on that definition, corruption is clearly a type of deliberate or accepted conflict of interest in which the interest of the agent is illegitimate<sup>19</sup>.

Some recent work in experimental psychology may help us to understand the breadth and depth of the moral problem involved in conflicts of interest that are merely potential<sup>20</sup>. As a rule, we tend to assume that competent, independent, well trained and prudent professionals will be capable of making the right decision, even in conflict of interest situations, and therefore that the real problem is how to prevent conscious and voluntary decisions to allow one’s own interests (or those of third parties) to prevail over the legitimate interests of the principal<sup>21</sup> – usually by counterbalancing the incentives to act wrongly, as we assume that the agents are rational and make their decisions by comparing the costs and benefits of the various alternatives.

Beyond that problem, however, there are clear, unconscious and unintended biases in the way agents gather, process and analyze information and reach decisions that make it particularly difficult for them to remain objective in these cases, because the biases are particularly difficult to avoid. It has been found that<sup>22</sup>,

- The agents tend to see themselves as competent, moral individuals who deserve recognition.
- They see themselves as being more honest, trustworthy, just and objective than others.
- Unconsciously, they shut out any information that could undermine the image they have of themselves – and they are unaware of doing so.
- Also unconsciously, they are influenced by the roles they assume, so that their preference for a particular outcome ratifies their sense of justice in the way they interpret situations.

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<sup>17</sup> Cfr. Argandoña (2000).

<sup>18</sup> Cfr. Nye (1967), 61. The definition given should also include private offices or positions; cfr. Argandoña (2003).

<sup>19</sup> Corruption is always *de facto*: the mere possibility or temptation of corruption does not constitute a moral wrong, although the principle that nobody should expose herself to the risk of corruption without sufficient reason remains valid.

<sup>20</sup> Among recent studies on conflicts of interest that take account of these contributions from psychology are Cain et al. (2003), Chugh et al. (2003), MacCoun (2003), and Moore et al. (2002).

<sup>21</sup> With respect to conflicts of interest among auditors, this thesis is shared by, for example, Antle (1984) and Simunic (1984). It also seems to be the attitude of doctors; cfr. Moore (2001).

<sup>22</sup> For the references to support the arguments that follow, see Chugh et al. (2003) and MacCoun (2003). Moore et al. (2002) develop these arguments for the specific case of conflicts of interest involving auditors. Some of their conclusions are particularly interesting: a) the auditor tends to slant her judgment in favor of her client, whoever the client may be; b) not only the auditor’s report appears to be biased, but also her private judgment; c) the greater the financial interest involved and the closer the personal relationship between the auditor and the client, the stronger the bias; d) even relatively moderate incentives are sufficient to bias judgment; e) the thing that creates the strongest bias is the sense of responsibility toward the firm being audited; and f) the likelihood and strength of bias tend to be underestimated, even when incentives are established for the auditor to be impartial. Nelson (2003) reports empirical evidence on auditors’ biases.

- Often, their notion of justice is biased in their own favor. For example, in experiments in which two opposed parties' concept of fairness is questioned, both tend to consider precisely what favors them personally, even if disproportionately, to be the most fair.
- The agents are selective when it comes to assessing evidence; they are more likely to accept evidence that supports their desired conclusion, and tend to value it uncritically. If evidence contradicts their desired conclusion, they tend to ignore it or examine it much more critically.
- When they know that they are going to be judged by their decisions, they tend to try to adapt their behavior to what they think the audience expects or wants from them.
- The agents tend to attribute to others the biases that they refuse to see in themselves; for example, a researcher will tend to question the motives and integrity of another researcher who reaches conclusions that differ from her own. Generally speaking, the agents tend to give far more importance to other people's predispositions and circumstances than to their own.

For all these reasons, agents, groups and organizations believe that they are capable of identifying and resisting the temptations arising from their own interests (or from their wish to promote the interests of others), when the evidence indicates that those capabilities are limited and tend to be unconsciously biased.

## **The solutions**

A great variety of solutions has been offered to deal with the problems created by conflicts of interest. Whatever measures are taken will have to be chosen in light of the specific situation at hand and the circumstances.

Some solutions are intended to prevent conflicts of interest before they arise. These include the recusal of the person who has to make the decision, or the divestiture by the agent of her private interests. Others (not necessarily alternative but complementary to the preventive measures) are aimed at resolving conflicts after they have arisen. One example is disclosure<sup>23</sup>.

Issacharoff (2003) distinguishes between "substantive regulation" of conflicts of interest, aimed at achieving particular outcomes, and "procedural regulation", which focuses on the procedure to be followed in order to prevent conflict or facilitate conflict resolution.

Substantive regulations are easy to formulate (it can be done without having to go into the details of the relation that is to be prohibited), and convenient for the person in power or lawmaker who proposes them. And it is assumed that the threat of punishment will discourage the prohibited behavior. Yet they tend to be ineffective because they cannot take into account the variety of possible relations between the agent and the principal. Consequently, they are quite likely to discourage legitimate behaviors, or to prove incapable of preventing undesirable behaviors. Also, the agents may internalize the punishments,

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<sup>23</sup> The distinction is taken from Carney (1998). Cfr. also McMunigal (1998).

in which case the punishments will become part of the agents' analysis of the costs and benefits of acceding to a conflict of interest. Moreover, substantive regulations create ex ante uncertainty; are difficult to apply ex post (depending on the characteristics of the judicial or administrative system that must enforce them); may magnify the effects of a conflict of interest (by making it more important to avoid the punishment than to act in accordance with the interests of the principal), etc.<sup>24</sup>

For all these reasons, we may prefer process solutions, of which there are many different kinds: for example, creating an ethics committee in the organization (auditing firm, consultancy, law firm, hospital, etc.), whose job is to see to it that conflicts of interest do not arise and that, if they do, they are dealt with appropriately by removing the decision from the area in which the person subject to the conflict works. Or erecting "Chinese walls" between the different departments of a financial institution (or other type of professional organization) to control information flows between them. Or making it illegal for auditing firms to offer other services (business consulting, tax consulting, etc.) to clients for whom they act as auditors, etc.

In what follows we shall discuss some of the main solutions that have been proposed for the problem of conflicts of interest.

### ***Recusal of the person who must make the decision***

As was mentioned earlier, recusal is a measure aimed at preventing conflict before it arises. It consists of transferring the decision from the professional, official, executive or employee who is in danger of being compromised in the conflict of interest, to another person. For example, if a company's personnel manager has to decide whether or not the company should hire her husband; or if a professor has to grade her own son's exam; or if a civil servant or government official must decide whether or not to award a contract to a company owned by a relative<sup>25</sup>.

Recusal may be effective in conflicts that arise from outside the agent's profession or office (external or private conflicts), provided such conflicts are not too common and provided the recusal can be done without causing major difficulties. But it will not be feasible in many internal or professional conflicts<sup>26</sup>, where the problem is rooted in the professional relationship with the principal.

### ***Divestiture of private interests***

Divestiture is another measure aimed at conflict prevention. It consists of placing an obligation upon the agent to dispose of any private interests, either at the time of taking up her post, office or profession, or whenever the conflict of interest appears. For example, a central bank executive or finance ministry official may be obliged to dispose of any shares she owns in the financial institutions with which she will be dealing in her new position, or to leave the boards of directors of the companies of which she was a shareholder. Or the

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<sup>24</sup> Cfr. Issacharoff (2003).

<sup>25</sup> Often, in this type of situation, it is best not to disclose the conflict of interest, as it may prompt the person appointed to make the decision to try to ingratiate herself with the agent involved in the conflict of interest, thus creating the very problem that the measure is intended to avoid.

<sup>26</sup> The contrast between external or private conflicts and internal or professional conflicts is taken from Stark (2003).

company's purchasing director may be required to dispose of any shares she holds in companies that she will be dealing with as suppliers in her new job<sup>27</sup>.

This type of measure can be particularly onerous for the agent, as it involves accepting a financial loss, or abandoning a business activity to which she may have to return (when she leaves her post or office, for example).

### *Disclosure of private interests*

Conflicts of interest arise in situations of asymmetric information. The purpose of disclosure is precisely to correct such asymmetry by ensuring that the principal is informed about the nature and extent of the conflict of interest. Disclosure is probably the most common solution to the kinds of problems we are talking about here – and often it will also be a moral duty, insofar as concealing a conflict of interest is a way of misleading or deceiving the principal, and may cause harm to third parties. Disclosure may take various (non-mutually exclusive) forms. For instance:

- Disclosure of private interests that may conflict with the agent's professional, contractual or legal duty. For instance, a senior governmental, legislative, judicial or regulatory official may be required, on taking possession of her office, to submit a report detailing any personal and family interests (business interests, share ownership, etc.) that may interfere with the independence and honesty of her decisions in the future. In some countries a record of these private interests is kept in a register that is open to the public or only to certain monitoring bodies, and subject to periodic review or update<sup>28</sup>.
- Disclosure of conflicts of interest to the agent's superior or to a monitoring body as soon as they arise. For example, a public official or a manager may be required to declare the existence of a conflict of interest if she has to decide about the award of a contract when one of the bidders is a company in which she has a personal financial interest or which is owned by a close relative.

Following this initial disclosure of private interests, various solutions may be adopted, such as the recusal of the agent from the decision that gives rise to the conflict, disclosure to the principal of the existence of a conflict of interest so that the principal may decide for herself whether or not the agent should recuse herself from the decision, etc.

- Disclosure of conflicts of interest to the principal. For example, a doctor may be required to explain to the patient whom she invites to join a group taking part in a research project that she receives a payment for each new patient that joins the group. It is assumed that the agent will inform the principal truthfully, clearly, and in detail about the conflict of interest, and that this will enable the principal

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<sup>27</sup> Numerous variations on this type of measure are possible. For example, the agent may be required to sell the shares immediately, or communicate her interest to an independent body, which will decide whether or not they must be disposed of. Or ownership of the shares may be transferred to a "blind trust", managed by another person, without the involvement or knowledge of the agent. Or the agent may be allowed to retain her private interest, but subject to monitoring by a supervisory body. On these kinds of solutions, cfr. Carney (1998).

<sup>28</sup> This register may raise problems of invasion of the agent's privacy, and may discourage potential candidates for public office. Carney (1998) offers some useful recommendations on declarations of conflicts of interest.

to make an informed and voluntary decision, either to withdraw from the mutual relationship or to take other protective measures<sup>29</sup>.

- The logical counterpart of the disclosure of conflicts of interest by the agent is informed and voluntary consent by the principal. However, there are some situations in which, if there is a conflict of interest, the principal cannot give her consent (non-consentable conflict)<sup>30</sup>.
- If the conflict of interest situation is self-evident, disclosure may not be necessary. Nonetheless, even in such cases it is an advisable precaution<sup>31</sup>.

Disclosure of private interests has unquestionable advantages:

- It saves the agent the disadvantages of having to renounce making a decision that is hers by office or professional qualifications, or having to renounce legitimate private interests.
- It simplifies the job of the person in power or regulator, who is released from the obligation to monitor any conflicts of interest that may arise, the responsibility falling instead on the agent.
- It helps the agent to appreciate the risk she runs and make it compatible with her interests.
- It improves the efficiency of social and market mechanisms by at least partly resolving the problem of asymmetric information.
- It is particularly useful in some professions – legal practice, for example<sup>32</sup>.

But it also has certain drawbacks<sup>33</sup>:

- It does not eliminate the problem, it merely makes it known. Ultimately, there is nothing that can save the principal having to assess the moral quality of the agent in the particular case at hand.

<sup>29</sup> Morin et al. (2002) point out how unlikely it is that a process of this kind will lead to free and “informed consent” by the patient. Ueltzen and Dean (2001) detail the conditions that a disclosure of this kind must meet in the case of an auditor.

<sup>30</sup> Cfr. Moore (1997), on conflicts of interest among lawyers in the United States.

<sup>31</sup> It is sometimes suggested that conflicts of interest should not be disclosed because the advantages, even if there is a conflict of interest, are greater than the disadvantages – for example, because a patient’s participation in an experiment will have important benefits for medical science. Or because the conflict of interests is considered unavoidable – for example, if a doctor has invented a new prosthesis, only she can place it. Nevertheless, it appears to me that, in these cases, the agent still has a duty to inform the principal, so that the principal can make an informed and voluntary decision, after weighing the consequences for herself and for society. Cfr. Moore (2001).

<sup>32</sup> MacCoun (2003) gives some reasons for this conclusion. A lawyer acts always in defense of a partial interest: nobody is going to imagine that a lawyer is an impartial seeker after truth. In a court case, both parties will have proper legal representation. There are standards of clear evidence, and an impartial judge who decides in light of the cases put forward. And the opposing parties’ positions probably map the limits of the truth. However, these conditions obviously do not apply in other professions.

<sup>33</sup> For a detailed analysis of some of these arguments, see Cain et al. (2003) and the bibliography given there.

- The principal will still have the problem of adapting her judgment to any information that is disclosed. For example, if a financial expert advises the principal to buy shares in a particular company and reveals that she herself owns shares in that same company, in what way and to what extent is the advice likely to be distorted as a result of the conflict of interest? How can the distortion be corrected? In other words, although disclosure removes or mitigates one of the causes of conflicts of interest –the high information costs– it cannot resolve another – the high monitoring costs.
- “Anchor effects” occur: the starting point influences the entire process, even if it is known to be irrelevant or biased. If the expert starts by recommending the shares of a particular company, that recommendation will condition all subsequent judgments, as experiments have shown. The principal will find it difficult to “forget” the information she has been given, even though she knows it to be biased, or even false. Information that is repeated earns greater confidence on the part of the principal. And information received earlier tends to acquire a higher truth status than information received later, even if it is known to be false.
- The principal tends to overestimate the role of the agent’s predispositions and underestimate the circumstances of the advice, including the fact that there is a conflict of interest.
- For all these reasons, the principal is unlikely to be able to fully discount the bias caused by the conflict of interest, even if it is honestly, completely and clearly disclosed.
- The disclosure will also influence the agent. On the one hand, it may make her more honest, because she knows that the principal will be more alert to possible biases.
- But it may also have the opposite effect, whether through strategic exaggeration (increasing the bias, so that it is not neutralized by any correction the principal may make); or through “moral license” (the agent considers that having disclosed her interest, she has already fulfilled her obligation toward the principal and from now on can safely ignore the principal’s interest)<sup>34</sup>; or because the fact of being obliged to disclose the conflict induces the agent to do so partially or incompletely.
- There is no guarantee that the disclosure will leave the principal any better placed to give her free and informed consent. For instance, if a doctor advises a patient to have treatment at a clinic in which the doctor has a financial interest and declares that interest, the patient still will not know whether the treatment is necessary, or whether the clinic that the doctor has recommended is suitable or not. And obtaining that extra information (for example, by seeking a second opinion) may be very expensive.
- Disclosure may weaken the principal’s confidence in the agent, owing to the conflict of interest; but it may also strengthen it if the disclosure is interpreted as

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<sup>34</sup> Cain et al. (2003) points out that, according to empirical studies, the agent’s bias is accentuated when the conflict of interest is disclosed.

proof of the agent's honesty. This may induce the principal to commit more serious errors of judgment<sup>35</sup>.

- If the disclosure of a conflict of interest is not reiterated at regular intervals, it may cease to have any effect on the principal's attitude.
- There are some conflicts of interest that cannot be resolved or mitigated by disclosure. For example, even if a researcher reveals that she has a financial interest in obtaining particular results from her work, we cannot be sure whether that interest has influenced her results (except by conducting an in-depth analysis of her work).
- In any case, if disclosure of a conflict of interest is not made out of moral conviction, there will have to be some incentive for the agent to effectively comply with the disclosure requirement, either in the form of a legal obligation (with the corresponding penalty in the event of non-compliance), or an obligation to pay compensation for harm caused (if no disclosure was made, or if the information disclosed was false or incomplete), or the threat of loss of reputation, etc.

### *Opening the field to competition*

If one of the root causes of conflicts of interest is the fact that there are barriers that prevent agents from competing with one another, then one way to prevent, or at least mitigate, such conflicts will be to open the field to competition.

In some cases, a market solution may be possible, provided that there is sufficient competition and the (financial, reputation, etc.) costs of conflicts of interest to the agent are recognized<sup>36</sup>. For example, banks have privileged information about the customers to whom they make loans, and they could use this information to their own benefit and against the interests of other customers. A bank could, for example, underwrite the flotation of shares by a company that owes the bank money, and advise its customers to buy those shares, with the aim of reducing the volume of the company's debt held by the bank and so reduce the risk it has in that company. Of course, in a competitive market, investors would be aware of this possible conflict of interest and would demand a risk premium for buying the shares, which would effectively reduce the shares' selling price. Conscious of this, and driven by competition, banks would have an interest in signaling to the market that they are willing not to be swayed by this conflict of interest, possibly by forming an underwriting syndicate with other respected banks<sup>37</sup>.

The market solution may be the most desirable, but it will only work if certain conditions are met, such as there being sufficient information about the nature of the conflict of interest, transparency about prevailing market conditions, and a sufficient level of competition (in terms of number of competitors, lack of differentiation of the product or service, etc.). In many cases, however, these conditions are not met. Therefore, opening the field to competition

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<sup>35</sup> This will depend on factors such as the intensity of the conflict, the suspicions of the principal, the nature of the disclosure of conflict (whether it is generic or specific, whether it is made by the agent or by a third party), etc.

<sup>36</sup> Cfr. Boatright (2000).

<sup>37</sup> There is evidence that this practice reduces the risk of conflict of interest and thus also the premium demanded by investors. Cfr. Narayanan et al. (2001).

may also be a conscious and ethical decision by the agent, who avoids any conflict of interest by offering the principal various alternative solutions. For example, if a client asks a tax consultant for advice on how to invest, the consultant may suggest various alternatives, including those in which she has a personal or family interest, which she will disclose.

Often, competition is complementary to other measures, such as disclosure of conflicts of interest, which helps to offset information asymmetries and so makes competition more effective<sup>38</sup>.

### *Structural changes*

Another set of measures prevents conflicts of interest or mitigates their effects by changing the structure and organization of the institutions in which such conflicts are liable to arise. These measures are aimed at correcting the information asymmetry mentioned earlier, or reducing the expected benefit of satisfying the agent's personal interest (by imposing fines, loss of reputation, etc.).

In financial institutions<sup>39</sup>, for example, measures have been taken to organize different functions in separate legal entities, or at least in divisions with different geographical locations, different management and different compensation systems ("Chinese walls"); limits on analysts' pay (so that it is not directly linked to individual deals, or directly or indirectly influenced by the investment bank's trading performance); rules prohibiting analysts from reporting directly to the investment banking arm; restrictions on analysts' private portfolios, etc.

Similar structural changes aimed at preventing conflicts of interest can also be made in organizations other than financial institutions. For example, rules that prohibit auditing firms from performing other services (such as business consultancy, for example). Or restrictions on the business activities that people holding particular public posts are permitted to engage in after leaving public office – on account of the insider information they have had access to or the influence they have acquired over government or regulatory activities<sup>40</sup>.

### *Other measures*

Professions, companies and organizations that are particularly prone to conflicts of interest must have rules designed specifically to identify conflicts and the risks they entail, so that they may be avoided or, if necessary, resolved in the best manner possible. These rules may be imposed by law, by regulations drawn up by an official regulator, or by individual industry, market or company codes of conduct, etc. They will include prohibitions<sup>41</sup>; internal

<sup>38</sup> In fact, disclosure of conflicts of interest without competition is ineffective; for example, if a town has only one clinical laboratory, in which all the local doctors have an interest. However, competition can also create incentives for conflicts of interest; for example, when the consequent fall in an auditing firm's profits encourages it to branch out into other lines of business that come into conflict with its work as an auditor.

<sup>39</sup> On the structural changes proposed in financial institutions, cfr. Boatright (2000) and Forum Group (2003).

<sup>40</sup> The restrictions have to do with the period of employment search and acceptance, private sector activities in areas related to the person's previous activity, relations with the public officials or politicians who take her place in her previous job, etc. Cfr. Carney (1998).

<sup>41</sup> For example, rule 1.7(b) of the *Model Rules of Professional Conduct* of the American Bar Association establishes: "A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests..." (quoted in Moore (2001), p. 9, note 41; see also Moore (1997), p. 548, note 45).

and external accountability mechanisms; management policies and systems, processes and practices designed to ensure that the interested parties accept their responsibility to comply with the letter and the spirit of the rules; auditing systems (both internal and external) to detect possible non-compliance; penalties; measures to protect disclosure and declaration of information by agents affected by conflicts of interest; guides and tools for communicating and publicizing the rules, and training in applying them, etc.<sup>42</sup>

### *Ethical attitudes toward conflicts of interest*

The solutions described in the preceding sections are, at least partly, rules provided by the legislator, the regulator or society to prevent conflicts of interest or mitigate their harmful effects. But if the agent wishes to act in accordance with ethical criteria, she will have to go further than that.

The first thing a person who is at risk of finding herself in a conflict of interest must do is take the matter seriously, as situations of this kind have important ethical implications, are quite common, and have non-trivial consequences for the person concerned, the organization or profession in which she works, and society as a whole. As has already been said, the agent must not knowingly put herself in a conflict of interest situation, unless she has sufficient reason to do so. And if she finds herself in such a situation, she must do her best to get out of it, if she can (for example, by renouncing her personal interest, or by handing the decision over to someone else). In any case, she must follow the rules laid down by the relevant law, regulations or code of conduct for conflicts of interest. But she must not confine herself to complying with these rules if they do not adequately resolve the problem at hand.

If the agent finds herself in a conflict of interest that she cannot avoid, she must follow the rules of prudential decision making. First, she must find out exactly what the situation is, in relation to whom the conflict of interest<sup>43</sup> has arisen, what kind of conflict it is, what her legal, fiduciary or professional obligations toward the principal are, and the relative importance of the conflicting interests. When studying the various alternatives, she must consider how each affects her duty of justice toward the principal and any third parties affected, and thus also the consequences of the action for herself, the people she works with, the principal, her client (if client and principal are not the same person), and third parties (including professional colleagues), without overlooking the risk of collaborating with the misconduct of others (by instruction, induction, advice, consent, instigation, participation or concealment).

Given the unconscious and unintended biases mentioned earlier, it is advisable to seek counsel from a person who has the necessary expertise and maturity of judgment (and accept and follow it if it seems correct); to analyze one's own and other people's experiences in similar situations (recalling what happened in the past is part of the prudential decision making process); and to exercise one's skill in finding solutions other than the one that seems most desirable at first sight (by considering the exact opposite strategy, playing devil's

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<sup>42</sup> Including regular reminders of the rules on conflicts of interest; information to new recruits to the organization or profession, as well as to third parties; repertoires of practical cases and best practices; information, help and counseling mechanisms, etc. Cfr. OECD (2003).

<sup>43</sup> Bearing in mind that it may affect several parties. For example, a lawyer representing the interests of a company will also have interests with respect to the company's owners, managers and other stakeholders. She will also have interests with respect to former clients who may be affected by the case.

advocate, presenting the arguments to an audience that thinks differently from oneself, developing the arguments from the principal's point of view...)<sup>44</sup>.

The agent must also be familiar with the criteria for an ethically correct decision: she must understand what obligations flow from her relation with the principal and the different ways in which she can commit an injustice. In these matters, a mere cost-benefit analysis is not a good way of finding a solution, as it usually does not take into account the most important effect that the immoral act will have on the agent herself and her moral learning – and also on third parties. And lastly, she will have to assume her own responsibility and follow her conscience<sup>45</sup>. And if she has made a mistake, she will have to be willing to ask for forgiveness (and learn from the mistake) and make good any harm that has been caused. In a word, it is a matter of acting as a competent and honest professional, manager, employee or public official.

In the case of companies, organizations, partnerships, etc., there is an institutional responsibility to be assumed in relation to conflicts of interest, by trying to prevent them as far as possible and seeing to it that they are resolved fairly, always in accordance with the law and ethics. Organizations must put in place the necessary rules (codes of conduct, for example), institutions (hotlines, ethics committees, compliance officers, internal and external auditors), and training procedures to instruct their members in the legal, professional and ethical criteria applicable to conflicts of interest (courses, public analysis and discussion of practical cases, etc.).

## Conclusions

Conflicts of interest are a very widespread ethical problem which, precisely for that reason, deserves special attention, both from a legal viewpoint and from the point of view of ethics applied to organizations and professions. In this paper we have explained what constitutes a conflict of interest, using the conceptual framework of agency theory. This has enabled us to identify what causes conflicts of interest, namely the divergence of the financial pay-out for the agent and the principal, the high information and monitoring costs, and the existence of entry barriers that limit competition between agents.

In view of all the above, we have analyzed the ethical criteria and the solutions commonly put forward for resolving conflict of interest situations. Because the way agents process information, judge and decide is subject to significant, unconscious and unintended biases, we have placed the emphasis on the conditions that an agent's decision in a conflict of interest situation must meet in order to be ethically correct.

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<sup>44</sup> This is the advice offered by Cain et al. (2003), p. 22 and MacCoun (2003), p. 14, precisely after explaining the biases mentioned above.

<sup>45</sup> The decision will have to take into account any collateral measures that may be required – for instance, to protect a client's confidential information in an investment bank or an auditing or law firm.

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