

# Applying virtue ethics to business: The agent-based approach

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*It can be argued that the presence of what are in a slightly old-fashioned terminology called virtues in fact plays a significant role in the operation of the economic system.*

- Kenneth Arrow

## Introduction

There are two basic approaches to integrating ethics in business: the action-based approach, and the agent-based approach. The traditional approach is action-based in that it focusses on developing rules or guidelines to constrain management's actions. These rules or guidelines generally manifest themselves in corporate codes-of-conduct, or codes-of-ethics.

Contrarily, rather than the action-based focus on rules governing action, the agent-based approach concerns the fundamental character and motivations of the individual agent. Under the agent-based approach, moral behavior is not limited to adherence to a rule or guideline but rather involves the individual rationally pursuing moral excellence as a goal in and of itself. In essence, ethics becomes central to the rationality concept as an objective rather than a constraint: "something positively good, ..something to be sought after" (Ladd, 1991, p. 82).

Agent-based approaches generally derive their philosophical foundation from virtue-ethics theory. This theory is attracting increasing interest from business ethicists. In essence, the 'virtue' in virtue-ethics is defined as some desirable character trait, such as courage, that lies between two extremes, such as rashness and cowardice. Thus the 'virtuous' agent is involved in a continual quest to find balance in decision-making. Such an agent does not apply any specific 'rules' in making decisions, but rather attempts to make decisions that are consistent with the pursuit of a particular kind of excellence that in turn entails exercising sound moral judgement guided by such 'virtues' as courage, wisdom, temperance, fairness, integrity, and consistency.

Rather than stepping outside one's professional role, virtue ethics would have one evaluate an ethically charged decision from within that role. Ethics becomes contextual and connected to a given person and situation, rather than separate and abstract to person and place. This is clearly a very different concept to that of ethics as adherence to a set of abstract rules, which is so common in contemporary professional codes of conduct.

For example, a financial accountant may be able to enhance her company's reported results of operations by crafting a sale-leaseback arrangement whereby some of the company's assets are sold, a gain is recorded, all the appropriate accounting pronouncements are adhered to, and the company still has use of its assets. The intent of the transaction was never to rid the company of unwanted assets, but rather to record a gain and thus possibly avoid breaching debt-covenant agreements or circumvent regulatory requirements.

In order to examine whether or not this example of creative financial-accounting is unethical, action-based approaches would have the individual step out of her accounting role and don the hat of a Kantian (e.g., "does this action violate the rights of users of the financial statements to fairly presented financial information?"), or of a utilitarian (e.g., "does this action maximize the welfare of all stakeholders?"). In this approach, the agent adopts a type of moral schizophrenia in which being a good professional in the sense of being an economically effective accountant becomes separable from being a good professional in the sense of being an ethical accountant. Thus, given this action-based approach, an accountant could be a 'good' accountant, in the sense of being very efficient and effective, yet at the same time not be a 'good' accountant, in the sense of being ethical.

The great strength of virtue ethics is that it overcomes this moral schizophrenia. Ethics is no longer merely a list of constraints on behavior. For example, our financial accountant, if she were virtuous, would not have to weigh the goal of maximizing firm profits against the constraints of an ethics code. Maximizing firm profits would simply no longer be her ultimate objective.

Indeed it is this holistic motivational focus, transcending contextual specificity, that is the great contribution of virtue-ethics theory. This theory provides an alternative value base upon which to build a morally sensitive theory of financial economics.

At first blush, however, the virtue-ethics approach might appear too esoteric for application in business: How could a financial manager pursue moral excellence through virtue? On closer scrutiny, however, the focus of virtue-ethics on the fundamental motivations of the agent actually dovetails rather neatly with the increasing focus among financial economists on the motivations of agents in business.

## Virtue Ethics: An Overview

Virtue ethics is concerned with pursuing a certain type of morally inclusive excellence. Aristotle called it eudaimonia, which can be roughly translated as 'happiness', or 'human flourishing'. For present purposes, this approach to ethics can be thought of as exhibiting four basic attributes. Its primary attribute is a strong emphasis on the importance of certain generally accepted virtues of character; indeed it is through honing and perfecting these virtues that an individual becomes truly ethical. Secondly, a strong emphasis is placed on the existence of an active community that nurtures these virtues. Thirdly, virtue-ethics theory makes clear that in the moral life one cannot rely merely on rules or guidelines, in addition an ability to exercise sound moral judgement is requisite. Finally, the successful identification and emulation of moral exemplars or role models is essential for the dissemination of morality within the aforementioned nurturing community.

The remainder of this article will describe virtue ethics from these four perspectives: the role of the virtues, the role of community, the role of moral judgement, and the role of exemplars.

### *The Role of The Virtues*

An essential feature of rationality within virtue ethics is that, rather than focussing on the material goals of the agent, it focusses on the character and motivations of the agent, and on the agent's ability to pursue a certain very particular type of excellence. A characteristic of this excellence is that its pursuit necessitates adherence to certain virtues or traits of character. These virtues place emphasis on the motivation for an action and entail the exercise of sound judgement. "Virtue lies in the reasons for which one acts rather than in the type of action one performs" (Annas, 1995, p. 250). Virtues can be split into two broad categories, namely self-regarding and other-regarding:

When, furthermore, we look at the whole range of traits commonly recognized as virtues, we once again see that self-regarding and other-regarding considerations are both capable of underlying the kind of high regard that leads us to regard various traits as virtues. *Justice, kindness, probity, and generosity* are chiefly admired for what they lead those who possess these traits to do in their relations with other people, but *prudence, sagacity, circumspection, equanimity, and fortitude* are esteemed primarily under their self-regarding aspect, and still other traits - notably *self-control, courage, and (perhaps) wisdom in practical affairs* - are in substantial measure admired both for what they do for their possessors and for what they lead their possessors to do with regard to other people. [Slote, 1992, p. 9, emphasis added]

A succinct definition of virtue is supplied by MacIntyre: "A virtue is an acquired human quality the possession and exercise of which tends to enable us to achieve those

goods which are internal..." (1984, p. 191). He distinguishes between internal and external goods as follows:

It is characteristic of what I have called external goods that when achieved they are always some individual's property or possession. Moreover characteristically they are such that the more someone has of them, the less there is for other people. ...External goods are therefore characteristically objects of competition in which there must be losers as well as winners. *Internal* goods are indeed the outcome of competition to excel, but it is characteristic of them that their achievement is a good for the whole community who participate in the practice. [1984, pp.190-191; emphasis added]

The pursuit of external goods, therefore, is no longer recognized as the ultimate end of human endeavor, but rather as a means to the achievement of excellence. Martha Nussbaum defines this excellence as "the end of all desires, the final reason why we do whatever we do; and it is thus inclusive of everything that has intrinsic worth [i.e., internal goods], lacking in nothing that would make a life more valuable or more complete" (1991, p. 38).

A central feature of virtue ethics is its concept of professional development as fundamentally a moral process; "one cannot be practically rational without being just - or indeed without the other central virtues" (MacIntyre, 1988, p. 137). Thus rather than being some peripheral appendage or constraint on a substance-based rationality concept, this approach places morality at center stage. In a business context, Kenneth Goodpaster lists five key virtues:

(1) *Prudence* - neither too short-term nor too long-term in time horizon; (2) *Temperance* - neither too narrowly materialistic (want-driven) nor too broadly dispassionate (idea-driven); (3) *Courage* - neither reckless nor too risk-averse; (4) *Justice* - neither too anarchic regarding law nor too compliant; (5) *Loyalty* - neither too shareholder-driven (private sector thinking) nor too driven by other stakeholders (public sector thinking). [1994, pp. 54-55]

Clearly, to achieve excellence through the exercise of these virtues of character requires a sense of moderation. Thus managers who are said to be 'weathering the storm' or 'sticking to their guns' may well be exercising the virtue of courage. But so might a manager who 'knows when to call it quits'. It is the reason or judgement underlying the action that will determine whether the agent is truly courageous. Thus a virtue is not a maximum or a minimum. Unlike rationality in the finance paradigm, practical rationality concerns moderation and balance.

The crucial difference, therefore, between traditional approaches to business ethics and the approach adopted in virtue-ethics theory is that the latter focusses on the character and motivations of the agent, and on the agent's ability to pursue excellence through virtuous acts. As mentioned earlier, Klein succinctly distinguishes between the traditional approach to business ethics and the new virtue-ethics approach by labelling them as "action-based" and "agent-based" respectively: the former tending to focus on moral rules that can be generally applied to contractual situations (e.g. Kantianism and utilitarianism), whereas virtue ethics concerns the aspirations of the agent, and the agent's ability to exercise the moral 'virtues'. Klein describes a similar individual in his analysis of Cervantes's *Don Quixote*:

The ideal of craftsmanship is to create that which has quality or excellence; personal satisfaction, pride in accomplishment, and a sense of dignity derived from the consequent self-development are the motivations. In an 'excellent' company it is this ideal that permeates the firm, and management should provide the moral example of such an ideal; a business management craftsman attempts to create a quality organization, and quality products and services are the result of such an organization. [1998, p. 55]

Klein's managers recognize their business universe as essentially one of chaotic disorder and unpredictability where rules of logic and rationality will never fit comfortably. These managers endeavor to achieve some sort of balance and harmony in their chaotic environment. In this endeavor they are not quixotic, but rather are guided by conceptions of quality, excellence, the Good, Aristotelian eudaimonia, and by conceptions of desirable character traits -- virtues -- that may lead to these ideals. The acquisition of these character traits and the concomitant pursuit of these ideals is not achieved simply by the application of certain rules of logic, or of rationality. Indeed the whole pursuit is characterized by a marked absence of rules and set goals.

#### *The Role of Community*

Virtue ethics theory also has implications for the role of the firm or professional organization. For the virtues to flourish requires a conducive infrastructure: "one cannot think for oneself if one thinks entirely by oneself, .. it is only by participation in a rational practice-based community that one becomes rational .." (MacIntyre, 1988, p. 396). MacIntyre defines a **practice** as ...

.. any coherent and complex form of socially established cooperative human activity through which goods internal to that form of activity are realized in the course of trying to achieve those standards of excellence which are appropriate to, and partially definitive of, that form of activity, with the result that human powers to achieve excellence, and human conceptions of the ends and goods involved, are systematically extended. [1984, p. 187]

Thus rationality in virtue ethics is a shared rationality with a shared conception of what is ultimately desirable in all human endeavor. This shared conception must be supported by, and indeed be the *raison d'être* of, the organizations and institutions that control and direct human activity. This infrastructure is an aspect of what was known in the city-states of ancient Greece as the polis: "the form of social order whose shared mode of life already expresses the collective answer or answers of its citizens to the question 'What is the best mode of life for human beings?'" (ibid., p.133). Such an infrastructure is essential for virtue ethics:

Aristotle is articulating at the level of theoretical enquiry a thought inherited from the poets when he argues in Book I of the *Politics* (1252b28-1253a39) that a human being separated from the polis is thereby deprived of some of the essential attributes of a human being. .. A human being stands to the polis as a part to its whole. .. For the polis is human community perfected and completed by achieving its *telos*. [Ibid., p.96-97]

The virtue-ethics approach thus casts the firm or professional organization in a role that is far more active and intrusive than merely what Jensen and Meckling call a "contractual nexus" (1976) or what Miller describes as a "wealth creating machine" (1986). The firm becomes a nurturing community, a polis. "Corporations are real communities, ..and therefore the perfect place to start understanding the nature of the virtues" (Solomon, 1992, p.325). Solomon emphasizes the link between virtue-ethics and this expanded role of the firm as a nurturing community: "It [virtue-ethics] is an Aristotelian ethics precisely because it is membership in a community, a community with collective goals and a stated mission - to produce quality goods and/or services and to make a profit for the stockholders" (Solomon, 1992, p.321). Within the rubric of virtue-ethics theory, therefore, the goals and aspirations of the individual are nurtured and directed by the business organizations and institutions of which that individual forms a part.

#### *The Role of Moral Judgment*

Another significant aspect of virtue ethics is its rejection of a rule-based approach to moral education. Acting ethically in a given situation is less a function of rule adherence and more a function of exercising sound moral judgement. MacIntyre makes this very clear:

What can never be done is to reduce what has to be learned in order to excel at such a type of activity to the application of rules. There will of course at any particular stage in the historical development of such a form of activity be a stock of maxims which are used to characterize what is taken at that stage to be the best practice so far. But knowing how to apply these maxims is itself a capacity which cannot be specified by further rules, and the greatest achievements in each area at each stage always exhibit a freedom to violate the present established maxims, so that achievement proceeds both by rule-keeping and by rule-breaking. And there are never any rules to prescribe when it is the one rather than the other that we must do if we are to pursue excellence. [1984, p. 31]

This does not mean that, for example, derivatives traders should ignore exchange standards or codes of conduct, but rather that these should be viewed - not as the entire professional ethic - but as the foundation from which to pursue the professional ideal in this activity. This professional ideal will be defined in terms of the internal goods specific to the practice of derivatives trading, but more on this later.

#### *The Role of Moral Exemplars*

The role of exemplars is critical for the application of virtue ethics because it is from these individuals that the virtues are disseminated throughout the profession. Thus, in virtue ethics, ethics is something which is *learned* through observation of others' behavior. For example, in his article on "Good Works", Michael Pritchard concludes that "beyond discussing codes of ethics, principles of right and wrong, dilemmas ... and moral disaster stories, we need stories of a different sort - *stories of good professionals whose lives might inspire emulation*" (p. 170, emphasis added). A resurgence in recognition of the critical importance of moral exemplars is supplied by cognitive science in its invocation of "exemplar theory". Alvin Goldman summarizes the theory as follows:

Moral theorists often assume that people's usage of moral terms is underpinned by some sort of rules or principles they learn to associate with those terms: rules

governing honesty, for example, or fairness. The exemplar theory suggests, however, that what moral learning consists in may not be (primarily) the learning of rules but the acquisition of pertinent exemplars or examples. This would accord with the observable fact that people, especially children, have an easier time assimilating the import of parables, myths, and fables than abstract principles. A morally suitable role model may be didactically more effective than a set of behavioral maxims. [1993, p. 341]

In summary, what this overview of virtue-ethics theory makes clear is that an individual, whether finance professional or otherwise, cannot be ethical in a vacuum. The individual must be educated in the virtues by a nurturing community, and by the guidance of exemplars. This approach takes ethics far deeper than merely a credo or code of conduct. Ethics becomes integral to the professional's whole conception of what it is he or she is about. Rather than the opportunist of financial agency theory, the virtuous agent adopts a different notion of substantive rationality: Practical Rationality.

### **Virtuous behavior: Practical Rationality**

A chess championship recently took place in London between the reigning champion, Gary Kasparov, and a British challenger, Nigel Short. The winner of the tournament was to receive some \$2 million in prize money. Imagine that one of the players, say Kasparov, is 'rational' in the economic sense as invoked by the finance paradigm, while the other player, Short, is 'rational' in the sense of Aristotelian *practical rationality* as invoked by virtue-ethics theory. How, exactly, would these two individuals differ in their approach to the chess tournament?

Clearly the *actions* of the two agents may be indistinguishable. They would both be playing chess to the best of their ability, and would both be playing to win. Clearly, also, either player could win. The difference between the two players would likely rest entirely on their respective motivations for winning. Kasparov's motivation would derive from the *external goods* to be gained from playing chess, namely the \$2 million prize money and perhaps also the fame and power that comes from being 'the champion'. Contrarily, Short's motivation would derive from the *internal goods* to be gained from playing chess. These goods are less easily identified. They are, as MacIntyre notes, "those goods specific to chess, .. the achievement of a certain highly particular kind of analytical skill, strategic imagination and competitive intensity .." (1984, p. 188).

In essence, Kasparov views chess as a means to an end, where the end is wealth, fame, and power. Short, on the other hand, views chess as an end in itself. To the practically-rational Mr. Short chess is a "practice"; indeed an understanding of the concept of a practice is central to an understanding of practical rationality.

What the rationality embedded in virtue-ethics makes very clear is that excellence within a practice is *in and of itself* a moral excellence; the pursuit of excellence in a practice necessitates the exercise of the virtues. "A virtue tends to enable us to achieve those goods which are internal to *practices* and the lack of which essentially prevents us from achieving any such goods" (1984, p. 191, emphasis added). Thus a practically rational financial manager would be one who views financial management as a practice, with goods internal to the activity itself. Contrarily an economically rational financial manager is one who views financial management primarily as a means to the attainment of external goods. This latter financial manager or agent is the one who currently populates the models of agency theory.

Both types of financial manager will pursue what they perceive as their self interest. In the case of practical rationality, however, the agent's self interest is defined in terms of the pursuit of excellence within the practice. Furthermore this pursuit will be undertaken through the exercise of the virtues within a community (the *polis*).

Thus practical rationality is an interactive or connected rationality. A practically rational agent pursues happiness or excellence (what Aristotle termed *eudaimonia*) while realizing that this pursuit cannot be successfully undertaken opportunistically: the achievement of happiness requires the exercise of the moral virtues such as honesty in dealings with others.

### **Acid-Test: Derivatives Trading**

Many outside observers view derivatives trading -- as undertaken by hedge funds such as the George Soros fund, or Long-term Capital Management (LTCM) -- as the epitome of the ugly face of global capitalism: it appears to be an activity premised purely on the short-term acquisition of material wealth through the creation of complex and artificial financial instruments. But, as is usually the case, on closer scrutiny things are not so simple.

Although outright speculation undoubtedly explains much derivatives trading activity, it does not explain the whole market. Take, for example, two of the most popular trading strategies employing derivatives, namely portfolio insurance and index arbitrage. Without getting into the technicalities, the essential objective behind portfolio insurance is -- as the name implies -- to insure a portfolio against heavy losses. This is generally achieved by entering into derivatives positions that become profitable if the portfolio to be insured loses value. Similarly, the objective behind index arbitrage is not to maximize profits *ad infinitum* but rather to lock in a modest risk-free return. This is achieved by exploiting the 'spread' between the value of a futures contract and the corresponding spot value.

Rather than simple wealth maximization, therefore, such strategies are better described as risk management. Furthermore, they involve the application of a substantial body of sophisticated knowledge that evolves through time. There is an excellence to pursue here, namely the development of a trading strategy that successfully meets some risk-management goal. The activity is also communal: traders work in various groups that pursue certain common goals. For example, the traders in a 'pit' on the London-International-Financial-Futures-Exchange (LIFFE) share the common goal of maintaining as liquid a market as possible for their particular contract; or the traders in a trading room of a financial institution share the common goal of meeting performance targets and designing contracts that meet the risk-management needs of clients. But could this activity be reasonably viewed as what MacIntyre defines as a practice?

There are three basic characteristics of derivatives trading that define it as a **practice** within virtue ethics:

- **First, it establishes its own standards of excellence in the design and successful implementation of the various trading strategies summarized above.**
- **Second, there are particular internal goods specific to derivatives trading. As always with the concept of internal goods it is hard to find words to define them. In After Virtue, in the context of chess, MacIntyre defines the internal goods as analytical skill, strategic imagination and competitive intensity. All these would seem to be eminently applicable to derivatives trading.**
- **Third, derivatives trading is undoubtedly organic. These markets are continually changing as new strategies and contracts are being developed all the time.**

In short, there is no reason why the tenets of a practice-based community cannot be applied to even the most cold-bloodedly technical of business activities, namely derivatives trading. Such a derivatives trading organization would be one in which its members viewed themselves as engaged in the pursuit of the internal goods unique to the practice of derivatives trading; e.g., the successful application of the theoretical tools of option-pricing theory, or the ability to design a portfolio insurance strategy that meets as closely as possible the stated risk-management objectives.

### **Conclusion**

For the virtues to be successfully applied to business, business activity must be viewed as a 'practice' as defined above. Whether or not any business activity qualifies as a practice depends less on the type of activity, and more on the character and motivations of the people engaged in it. The challenge that any organization faces, therefore, is to educate managers as to the desirability of virtue-based behavior.

As a 'true professional', the good manager strives to achieve a certain specific type of morally inclusive excellence. One critical feature of this excellence is that its achievement entails adherence to certain 'virtues' of character, such as honesty, fairness, prudence, and courage. The excellence pursued by the true professional, therefore, is not something that can be measured in strictly material terms, it is a moral as well as an economic excellence. Albeit hard to quantify, individuals or 'exemplars' who have achieved this excellence are generally identifiable by their predisposition to place personal integrity over and above any material considerations.

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