THE ETHICS OF "COMMERCIAL BRIBERY": INTEGRATIVE SOCIAL CONTRACT THEORY MEETS TRANSACTION COST ECONOMICS

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D. Bruce Johnsen

ABSTRACT. This article provides an *ISCT* analysis of commercial bribery focused on transaction cost economics. In the language of Antitrust, commercial bribery is a form of vertical arrangement subject to the same efficiency analysis that has found other vertical arrangements potentially beneficial to consumers. My analysis shows that actions condemned as commercial bribery in the Honda case (1996) may well have benefited Honda's dealer network once promotional free riding and other forms of rent seeking by dealers are considered. I propose that the term "commercial bribery" should be avoided until after an *ISCT* analysis shows that the community is likely to have been harmed. The term "third-party payments" is a more ethically neutral term with which to begin the analysis.

KEY WORDS: business ethics, commercial bribery, dealer promotion, ethical rent seeking, federalism, free riding, informational role of prices, *ISCT*, transaction cost economics, vertical arrangements

Introduction

I was delighted to have been asked to contribute to this special issue of the *Journal of Business Ethics* in honor of Tom Dunfee and his scholarly contributions to the field. As one of the many junior scholars Tom nurtured through an early career, I owe him an immense debt of gratitude for his patient attention, his thoughtful comments and encouragement, and his inviting collegial demeanor. He put me at ease with who I am as a scholar and was truly an exceptional colleague and friend.

One of the things I enjoyed most about Tom was that he was unflappable. He took point blank criticism of his ideas without a ruffle. Had he not, I might quickly have become an ex-colleague. As with all exceptional scholars, the only important question on his mind was whether, and how, he could improve and advance his ideas. I am routinely impressed with his work on *Integrative Social Contract Theory* (*ISCT*), both for his knowledge of "higher philosophy" and for his intellectual integrity and determination in bringing it to bear on the field of business ethics in a way that can provide practical guidance to those whose heads might otherwise spin out of control when confronted with any but the most mundane ethical dilemmas.

I should say at the outset that I largely embrace the general structure and objectives of *ISCT* as Tom and others have developed it. *ISCT* is intellectually congruent with western philosophical discourse as reflected in its reliance on global "hypernorms" and at the same time practical and approachable in its reliance on local "authentic community norms" that allow for substantial "moral free space." This leads to the intuitively appealing result that business ethics is not a one-size-fits-all prescription for all commercial communities in all parts of the world at all times.

The layered structure of *ISCT* strikes me as akin to the notion of competitive federalism in political and economic theory. It allows for local variation – "laboratories for experimentation"[1] – minimally

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constrained from above to the extent necessary to mitigate intercommunity spillovers. *ISCT* emphasizes the moral force of the individual's options to exit from and exercise voice in local communities. These options ensure local norms are subject to evolutionary competitive forces.

Most of what I will have to say in this essay derives from my scholarly focus on the economics of transaction costs, a powerful branch of industrial organization economics most closely associated with the work of Nobel Laureate Ronald H. Coase (1937, 1960).[2] According to transaction cost economics, law, ethics, and other evolved institutions serve, at least in part, to constrain socially inefficient behavior. Successful application of transaction cost economics to the field of Antitrust demonstrates its power in helping courts understand otherwise puzzling business practices and to adjust the legal constraints accordingly. I believe it can be equally powerful applied in the context of *ISCT*.

My intentions in this essay are modest. After having reviewed a selection of Tom's work (some of it with very capable coauthors) explaining *ISCT* and applying it to "commercial bribery,"[3] I provide several comments based on transaction cost economics that I hope Tom's successors can use to improve and advance its practical application. Some of my comments may address questions already asked and answered outside my purview, for which I beg the reader's indulgence.

Economics, ethics, and law

The basics of ISCT

In *Ties that Bind*, Donaldson and Dunfee (TD2) describe the structure of *ISCT* and its rationale. They start with the plausible proposition that people are limited by "bounded moral rationality," which leads them to the two following conclusions. First, those called on to make ethical decisions "are constrained in their ability to discover and process morally relevant facts." Second, even ethical theorists "are constrained in their ability to devise a calculus of morality that coheres well will settled moral opinions." (1999, p. 29). People, therefore, face significant ethical uncertainty, a problem compounded in business settings by the huge variety of commercial systems in which people transact.

Owing to this variety, a one-size-fits-all approach would be decidedly inefficient, and no one can doubt that efficiency is at least *one* important concern for business ethics. Just as the substance of commercial (and other) law varies from one community to the next, so too must business ethics be allowed to vary so as to efficiently fill out the behavioral interstices that lie beyond law's effective force. *ISCT* embraces moral free space sufficient to allow substantial variation in ethical norms across local communities.

Local communities are free within an *ISCT* framework to specify appropriate ethical norms for commercial conduct as the product of a microsocial contract based on constructive consent. As long as they meet certain conditions, such as substantial majority acceptance within the community and the option for community members to exit and exercise voice, these local norms achieve the status of authenticity. Within the community, authentic norms carry a presumption of moral force as long as they are consistent with global, or macrosocial hypernorms derived from social contract and fundamental shared principles outside the community – much along the lines of Constitutional values in a federal system – which limit the scope of local community consent. Some hypernorms are procedural, such as the rights to exit and exercise voice; some are structural, such as those supporting essential political and legal institutions; and some are substantive, such as fundamental conceptions of "the right and the good" (TD2, 1999, p. 52).

Local community norms will come into inevitable conflict. This might occur because of globalizing trade that raises issues regarding conflicts of norms. It might also occur *within* an identified community that consists of various vertically related subcommunities, as with corporate "stakeholders." When different community norms conflict and both are consistent with the above conditions, the conflict is resolved by applying the following priority rules:

(i) Transactions solely within a single community, which do not have significant adverse effects on other humans or communities, should be governed by the host community's norms;

(ii) Community norms for resolving priority should be applied, so long as they do not have significant adverse effects on other humans or communities;
(iii) The more extensive the community that is the source of the norm, the greater the priority which should be given to the norm;
(iv) Norms essential to the maintenance of the economic environment in which the transaction occurs should have priority over norms potentially damaging to that environment;
(v) Where multiple conflicting norms are involved, patterns of consistency among the alternative norms provide a basis for prioritization;
(vi) Well-defined norms should ordinarily have priority over more general, less precise norms.

It is worth noting that TD2 refrain from over-engineering *ISCT*. They disagree with critics who argue they must specify the source of hypernorms. They also eschew a detailed listing of hypernorms, apparently leaving that task to ethical theorists applying *ISCT* to specific ethical dilemmas.

Necessary social efficiency and the commonwealth

Most important among structural hypernorms, TD2 assert, is what they call ''necessary social efficiency'' (1999, pp. 117–38). On one level, this hypernorm appears to reflect their pragmatic belief that business is largely an efficiency-regarding activity. People attempt to make the best they can within a limited budget, which requires all kinds of economizing choices, regardless of what one considers the relevant maximand. All else being equal, for example, an ethical system that achieves a given level of justice or aggregate welfare is better than one that achieves the same level of justice or aggregate welfare at twice the cost in forgone alternatives.

Necessary social efficiency embraces the notion that there are goods so fundamental to social order that any society must necessarily pursue them. Some conception of justice or fairness is one such good, but so is ''aggregate welfare.'' Every society must provide some measure of fair treatment to its citizens and all are ultimately concerned with ''sustaining the least well-off members of society at a level of reasonable possibility concerning liberty, health, food, education, housing, and just treatment'' (1999, p. 119).

TD2 leave the exact role of efficiency in *ISCT* ambiguous. On the one hand, they seem to resist the common tendency to put higher values such as social justice in a different category from everyday economic goods (1999, pp. 117–138). On the other hand, Dunfee (2006) denies any congruence between necessary social efficiency and plain old efficiency when he states that necessary social efficiency is ''not coextensive with economic definitions of efficiency'' (2006, p. 307). The unanswered question is how to rationalize these two points of view.

As I am an economist, it should come as no surprise that I like to see people rely on the concept of efficiency. But if they are going to use it, they must use it all the way or not at all. Picking and choosing will only get them into trouble. As a cautionary note, it is a misconception to think that embracing economic efficiency inevitably leads down a slippery slope to a mosh pit of hedonism and greed. Efficiency is ultimately about the pragmatic task of balancing trade-offs. Noble acts of charity or the recognition of human dignity are easily seen as economic goods that weigh in the social efficiency calculus. They may weigh heavily, but at the margin they are nonetheless subject to trade-offs with other economic goods no matter how mundane.

As a foundational proposition, one cannot compartmentalize efficiency into different categories unless the two categories have absolutely no spill-overs. As long as people are willing to sacrifice some amount of guns and butter for more social justice or vice versa, the efficiency calculus applies jointly to both categories, which are then subject to optimization in achieving the overall maximand. Even if this was not the case, the logical impossibility of maximizing two variables at once is widely recognized (Hardin, 1968).

This leaves me wondering what TD2 have in mind as the single maximand for necessary social efficiency. That is, to what unified end is the application of necessary social efficiency directed? I interpret necessary social efficiency as akin to what I have termed elsewhere as maximization, or promotion, of the *commonwealth* (Johnsen, 1986). By

"wealth" I do not mean little green slips of paper. Nor do I mean the aggregate of tangible goods. Most important, wealth is a stock concept representing the capitalized value of future income flows discounted at the appropriate interest rate. Someone who maximizes wealth will appropriately consider the future consequences of his actions, assuming he (possibly indirectly through his offspring, heirs, assigns, or community affiliation) bears their burden or enjoys their benefit. People routinely forgo the opportunity to cheat in hopes of building trust, for example. A reputation for being trustworthy generates a flow of future benefits in the form of reciprocal trust, which in turn reduces verification costs and increases the net gains from trade.

This intertemporal framework highlights the importance of social capital investment, which in turn focuses attention on institutions such as law and ethics that allow people to form accurate expectations about their ability to capture investment returns. Law and ethical norms are examples of social capital. They are social in that the relevant community shares them in common, normally as nonrivalrous public goods that often exhibit network-type benefits.[4] The commonwealth is not the aggregate value of all individual wealth, it is the value of the capital – *social capital* – we share in common, as with the common law, consisting of both accumulated knowledge in the form of case precedent and evolved procedures for applying this knowledge to new disputes as they arise. Parallel to the common law is the body of ethical norms accepted within any community that mediate a host of human conflicts arising in the shadow of the law (see, e.g., Ellickson, 1991; Posner, 2000). Identification of the relevant community – who "we" are – depends on the problem at hand.

Maximization of the commonwealth embraces dynamic efficiency and seems to rationalize the ambiguity with necessary social efficiency. TD2 define aggregate welfare, in part, as ensuring the least well-off members of society the *possibility* of maintaining a minimum level of economic goods. Necessary social efficiency appears concerned with the institutions that provide people with the opportunity to achieve desired outcomes rather than with assuring specific outcomes. Similarly, maximization of the commonwealth envisions social institutions that provide community members with the opportunity to best achieve private gains from social interaction through productive investment. Similar to "rule utilitarianism," both are concerned with an institutional structure that leaves the day-to-day outcomes to private parties.

Some concerns about majority rule

TD2 rely in part on substantial majority assent to determine which norms are authentic, and when the norms of different communities come into conflict they rely on priority rules that embrace majoritarian principles to resolve the conflict. Reliance on majority rule is troublesome for at least two reasons, both of which can be seen as transaction cost problems. First, it fails to account for the intensity of individual preferences. If 90 out of 100 community members modestly prefer a norm of full disclosure in commercial transactions, but 10 – who, let us say, are the real rainmakers – prefer a norm of *caveat emptor* by a large amount (perhaps because they would like to keep proprietary information confidential), majority rule makes the community worse off. In any practical application of *ISCT*, it would be wise to keep this distinction in mind and to accommodate an appropriate weighting of preferences whenever possible. In many settings, this is difficult in practice because the high cost of transacting prevents explicit bargaining or negotiation by contending interest groups.

Second, substantial majority rule is subject to the problem of ethical rent seeking. One does not need to be an expert in political theory to understand that, absent procedural and substantive safeguards, majority rule can be used to exploit the minority. This is exactly why virtually all democracies are constrained by Constitutional or other limits on majority rule that protect the minority. Again, this can be seen at one level as a problem of excessively high transaction costs that prevents explicit bargaining or negotiation between the majority and minority.

One obvious example in the U.S. is the Fifth Amendment to the Constitution, which requires states and the federal government (presumably acting at the will of the majority or their agents) to pay just compensation to private parties (minorities) when their property is taken for public use. The Constitutional

requirement of just compensation for public takings approximates the notion of *Pareto* efficiency. If the majority is going to violate established property rights for the benefit of the community it must ensure the minority is no worse off as a result. Similar constraints exist in state corporation law, where minority shareholders are accorded the right to collect their proportionate value of the premerger firm – that is, the merger must leave the minority no worse off.

The question is how to protect the minority from shifting ethical norms when there are no equivalent mechanisms to ensure *Pareto* efficiency. A majority may come to believe it is ethical to provide full disclosure in commercial transactions, but it may also be true that a minority of commercial actors have invested in specific reliance on *caveat emptor* to protect their proprietary information. The old ethical norm gave them some basis to believe their expectations would be met. Yet, it cannot be said they have anything like a protected property right in the old ethical norm. No mechanism exists to provide just compensation for ethical shifts, and neither is there a credible mechanism by which the majority can bind itself against ethical rent seeking. In the realm of business ethics, this suggests *Pareto* efficiency must yield to *Kaldor-Hicks* efficiency, which allows any ethical revision in which winners win by more than losers lose, even if the losers go uncompensated.

Knowing ethical norms are subject to unexpected shifts in the prevailing consensus, people will respond by reducing their ex ante investments in reliance on existing norms. This imposes a potentially huge cost on society. The question then becomes whether changes in ethical norms are necessarily authentic just because they have the support of a substantial majority. Maybe the majority has engaged in an ethical taking. At the least, this possibility would seem to caution for a presumption in favor of established ethical norms, with a fairly high burden on the moving parties to overcome it. Stability in ethical norms is valued for its own sake to some extent, especially if transaction costs are sufficiently low that parties can organize around an aging default rule. It also suggests that those interested in developing *ISCT* should give some thought to hypernorms capable of identifying and limiting ethical rent seeking.

By way of example, Dunfee (2006) refers to scholars who take seriously the notion that once having developed new treatments for HIV/AIDS, big pharma may have an ethical obligation to provide these drugs to the African poor virtually for free. This seems to me to be both a bad idea and a disingenuous one. First, I recall conversations with Tom in which he told me that Nestle and other firms had offered to provide a drug free of charge to cure river blindness throughout the African continent. At least for many years the program was an abject failure because those responsible for delivering the drug lacked the market signals to get it to those who most needed it. Prices as an economic phenomena are not just about who gets the income from a commercial activity, they are also about providing informative signals to otherwise ignorant market participants – the ''man on the spot'' (Hayek, 1945) – about how best to allocate scarce resources.

Second, imposing such an ethical obligation on those who develop cures for horrible diseases at great cost is pure fabrication. Who gave the advocates of a purported shift in norms the moral high ground? They are certainly free, either individually or collectively, to buy the drugs from big pharma and to distribute them as they see fit. To say that A has a moral obligation to distribute its property in a way that makes B happy, even though B is fully capable of buying A's property and redistributing it, is pure ethical rent seeking.

It is also a bad idea that will likely have negative effects on all sorts of bystanders who have no way of identifying the losses they will suffer. Advocates may be able to take big pharma's existing property for their own and others' benefit in Round One, but why would big pharma bother to develop drugs to treat all sorts of new diseases in Round Two if there is a substantial probability of such rent seeking? This kind of proposal leads to underinvestment in social capital and a clear reduction in the commonwealth, and although it may not mandate retention of the status quo, it does help us focus on the problem and scope of unintended consequences.

The economics of commercial bribery

A note on conflicts of interest

My scholarship on the economics of conflicts of interest dovetails nicely with the subject of

commercial bribery. Many of the conflicts I have examined involve claims of self-dealing or unjust enrichment when agents accept payments from third parties with whom they do business on their principal's behalf – practices often ridiculed as bribery, kickbacks, or payola (Horan and Johnsen, 2008; Johnsen, 1994, 2008). These practices unquestionably involve real conflicts of interest, but at the same time some of them appear superior to the actual alternatives once subjected to the scrutiny of transaction cost economics. Where transacting is costly, perfection is an irrelevant benchmark.

Regulators and media commentators often respond to reports of such practices with shock and quickly declare that conflicts of interest cannot be tolerated. This strikes me as patently wrong. From the standpoint of economic theory, all principal–agent relationships involve an inherent conflict of interest in that the parties are motivated primarily by self-interest. In competitive markets, knowing principals routinely tolerate agency conflicts – and even some forms of self-dealing – because the benefits from using specialized agents properly motivated far outweigh the costs and because agents' compensation can be easily adjusted to ensure they are not unjustly enriched. To prohibit conflicts of interest in a market economy would severely and needlessly hamper specialization.

Agency law tolerates conflicts of interest as long as they are disclosed or, if not disclosed, as long as the agent can demonstrate after the fact that they were fair. This is sensible and, I should point out, the empirically evolved common law approach. The phrase ''conflict of interest'' identifies the set of activities in which agent self-dealing *might* occur. Agency law is, and in this essay I will argue *ISCT* can be, far more parsimonious than to condemn conflicts of interest wholesale.

Taxonomy and scope

It is important to start with an ethically neutral taxonomy. I consider the term ''commercial bribery'' to be pejorative. Using it at the beginning of an *ISCT* analysis risks raising a presumption the arrangement at issue is unethical. I will instead use the term ''third-party payments'' (3PPs) unless and until the *ISCT* analysis, properly informed by economic theory, leads to the conclusion that the arrangement is truly unethical and, therefore, deserves the pejorative label of commercial bribery. My analysis applies to situations in which 3PPs are made by one private party to another, normally in the context of an agency relationship, rather than in the case of what Hess and Dunfee (2000) terms ''coarse bribery of public officials.''

The economic function of prices

At a very basic level, bribes, kickbacks, and payola are nothing more or less than garden-variety prices. Like all prices, they transfer value between transacting parties. There is little doubt the transfer benefits both parties, at least as they see their own interests ex ante. Among all the methods of rationing scarce resources, price has the advantage that what one party gives up, the other party gets. The time buyers spend waiting on line, for example, generally provides nothing of value to a seller and does little to encourage him to increase supply. The value of the buyer's time is dissipated – a pure transaction cost. Anyone who experienced 1970s era gasoline ''rationing'' should appreciate this point.

By relying on price to allocate resources, both parties to a transaction are encouraged to adjust the good's attributes to maximize the gains from trade. If, compared to payment on delivery, widget buyers are willing to pay an extra 20 gizmos per widget for credit terms that cost the seller only 15 gizmos, sellers will happily bundle credit terms into the transaction for an increase in price of somewhere between 15 and 20 gizmos. If widget buyers are willing to waive any claim for direct damages from delayed delivery in exchange for a price reduction of 12 gizmos that saves the seller 14 gizmos, buyers will happily bundle a waiver into the transaction for a reduction in price of somewhere between 12 and 14 gizmos.

But transfer for a price accomplishes more than efficient bundling. One party's claim that his widget is worth 30 gizmos is more credible when that party is willing to accept 30 gizmos for a widget, and vice versa for the other party. The transfer has two components: a simple trade of one good for another and information about the value of the respective goods, all bundled attributes considered. However

distributed,[5] the parties' gains from trade are a private benefit, but the information itself is a nonrivalrous public good that credibly signals what they consider optimal resource allocation. Only if (and to the extent that) there are substantial spillovers from the transaction – costs or benefits that fall on outsiders – is the informational role of prices undermined (though not entirely eliminated).

The common criticism of price allocation is that it gives the rich an advantage over the poor. True, being rich, or well-capitalized, provides one with more opportunities than being poor, which is a good reason to try to be rich, at least within the rules of the game. However, it is a mistake to think that just because someone is rich he can escape the consequences of paying a dollar for something that provides only 75 cents worth of benefits. No one ever got rich that way, nor will they stay rich long if they routinely indulge in such losing propositions. In any event, in a market system those of relatively modest means often succeed at the margin in outbidding their richer rivals when they are able to generate greater value-added as a result. Value-added, not riches, is what gives market participants pricing power because capital tends to flow to more profitable uses.

Several points are worth noting about the important role prices play in an economic system. First, Coase made clear in his famous 1937 article *The Nature of the Firm* that, as informative as prices may be, they are also costly to use. Firms supplant market transactions – they ''make'' rather than ''buy'' – as a way of economizing on the use of prices. Along with *The Problem of Social Cost*, Coase's work on the firm spawned a huge literature analyzing how economic organization, including ethical norms, promote efficient resource allocation by reducing transaction costs. Where we see prices emerging for goods that have otherwise been unpriced or bundled with other goods for a single price, it suggests that the informational benefit a new price generates exceeds the transaction cost to the parties involved.

Second, even in some market transactions, people actively avoid relying on prices when they could easily do so. University degrees, for example, would hardly be worth the paper they are printed on if the university simply sold them to the highest bidders. Instead, the process by which students compete in the classroom for grades, and ultimately for degrees, involves nonprice rationing that creates value. Presumably, the better a university does this, the more it can charge students for tuition. Whether price or nonprice rationing is superior in any particular setting depends on their consequences for the wealth of the relevant community. Much of transaction cost economics is devoted to assessing such consequences.

Some of the most important developments in Antitrust law, for example, have come from the application of transaction cost economics to vertical arrangements involving various marketing (pricing-relevant) practices such as exclusive dealing, tie-in sales, vertical integration, territorial and customer allocations to dealers, and maximum and minimum resale price maintenance (RPM). The most telling story from courts' evolving approach to these and other vertical arrangements is that there are often compelling economic explanations for business conduct that appears sinister (anticompetitive) on its face. Many of these practices were once summarily condemned by Antitrust regulators and courts but have since been identified as potentially efficient and in the best interest of consumers.

ISCT, and the entire field of business ethic, is in somewhat the same position as Antitrust law was years ago. There is little consensus, let alone an informed or tested consensus, on where specific practices fall in the *ISCT* calculus. Third-party payments constitute one such practice. In order to appear incisive, some practitioners may rush to condemn 3PPs before they have been completely vetted in the scholarly or commercial communities. It, therefore, pays to take a close look at the facts of a real case involving 3PPs.

Third-party payments by auto dealers – the Honda case

In their article on marketing ethics and commercial bribery, Dunfee et al. (1999) (DSR) provide an *ISCT* analysis of various real-world cases, including the ''Honda'' case. Their description of the facts is as follows:

> During the 1980s and early 1990s, Honda dealers paid more than $15 million directly to Honda executives to get extra allotments of popular Honda and Acura

> models that typically sold at a premium to the manufacturer's sticker price. Gifts included shopping sprees in Hong Kong, cash, and checks for children's college tuition. Two dozen Honda dealers and executives were indicted, including senior vice presidents and regional managers. Two were convicted in court trials, and 20 pled guilty. At the trial of the two convicted officials, the defense claimed that bribery was an accepted practice at American Honda and was a way to keep salaries below the industry norm. Stanley Cardiges, the senior vice president in charge of sales, was the main benefactor of the bribery, receiving more than $5 million during a 10-year period when his salary was $125,000. Prosecutors called the case the largest commercial bribery case in U.S. history. Subsequently, 1,800 dealers sued in a class action, alleging that they were punished when they failed to pay exorbitant bribes. Honda ultimately settled the case for $330 million (Dunfee et al., 1999, p. 22).

There were actually several civil class action suits involving claims under the Racketeer Influenced and Corrupt Organizations (RICO) Act, the Sherman Antitrust Act, and various other statutes, by dealers claiming to have been excluded from preferential allotments by the payment system. My review of the U.S. District Court's ruling on defendants' motions to dismiss in *In Re American Honda Motor Dealerships Relations Litigation*[6] reveals the following additional allegations of fact by the plaintiffs, which I will assume are true based on the disposition of the case.

Honda marketing personnel pressured dealers to pay fees to participate in sales training seminars conducted by third-party vendors and received payments from these vendors that increased with the number of participating dealers. They also pressured dealers to pay fees to participate in group advertising activities conducted by third-party advertising firms and received payments from these firms that increased with the number of participants. The reported opinion mentions nothing about college tuition payments or Hong Kong shopping sprees, though these forms of payment may have been alleged in other civil actions. The Court appears to have accepted as true the defendant's claim that American Honda knew of the payment system and that the defendant's marketing executives received the payments in lieu of higher salaries. Finally, American Honda represented in dealer agreements that dealers would receive allotments of new cars on a ''fair and reasonable'' basis.

DSR offer several definitions of bribery, but the most appropriate for the Honda case is the one contained in U.S. statutes pertaining to private-sector commercial bribery, to wit: ''conferring a benefit on an employee, agent, or fiduciary with intent to influence the recipient's conduct in his principal's affairs'' (DSR 1999, p. 24). Compared to ''coarse commercial bribery of public officials,'' they acknowledge that an ethical evaluation of private-sector commercial bribery is more difficult, among other reasons because private-sector bribery may generate social benefits. These include, but are not limited to, the following:

> The bribe may serve to guarantee that the bribee chooses the ''best'' supplier for the organization for which he or she acts. Finally, doing harm to competitors may be seen as business as usual or, at most, one negative consequence in an otherwise entirely positive set of consequences (DSR, 1999, p. 28).

DSR find that the payments made to the American Honda marketing executives probably fail an *ISCT* analysis. This is because an Acura dealer who refused to cooperate with the payment system received an insufficient allocation of cars and was forced to sell his dealership. He was joined in his suit by 1,800 Honda dealers. From this, DSR conclude that, if these 1,800 dealers constituted a majority of Honda dealers, bribery was not an authentic norm of the community of all Honda dealers.

Here is where my concern about majority rule comes into play. Even if these 1,800 dealers were a majority, it is by no means clear that they would have dissented from the payment system ex ante had they known about it. Plaintiffs come out of the woodwork after-the-fact to join class suits when there is a pot of money to be shared. Since such rent seeking is virtually irresistible, little can be inferred about their ex ante preferences from participation, ex post, in a class suit.

Even if the 1,800 dealers would have dissented ex ante, their reasons for doing so may undermine their right to be heard. A plausible interpretation of the facts is that some of the aggrieved dealers were those who refused to participate in the sales training and group advertising programs that generated the

payments to American Honda marketing executives. At the time, they either knew of the payments and failed to exit or exercise voice, or they were ignorant of the payments and their refusal to participate in these promotional programs indicates possible free riding on the Honda brandname. Undoubtedly, a nontrivial number of the 1,800 dealers were simply outside the ambit of the payment system, with free riding being a nonissue.

In order to see why a dealer's refusal to participate in the promotional programs suggests free riding, consider how the payment system might be explained by transaction cost economics. The payment system surely falls into the category of vertical arrangements in Antitrust parlance. Over the years, Antitrust scholars and courts have increasingly recognized the efficiency of most vertical arrangements given the cost of transacting. In 2007, for example, the U.S. Supreme Court overturned the near 100-year precedent holding manufacturer-imposed minimum RPM illegal per se in *Leegin v. KSPS*, citing Coase's work in its rationale.[7]

RPM, sometimes known as ''fair trade,'' occurs when a manufacturer and its dealers agree that dealers will charge no less than the retail price the manufacturer prescribes. For years, Antitrust courts considered RPM to be a surreptitious attempt by manufacturers to induce its dealers to collude on price. This legal theory was increasingly criticized, however, because it failed to explain why an economically rational manufacturer would want to do it. An increase in retail prices will reduce sales, and unless the manufacturer raises its wholesale price a corresponding amount its profits will fall. But if higher wholesale prices are the manufacturer's goal, why bother prescribing retail prices; why not just raise the wholesale price and be done with it?

In 1960, Lester Telser published an influential article titled ''Why Should Manufacturers Want Fair Trade'' in the *Journal of Law & Economics*. Telser (1960) pointed out that any number of products sold at retail is more valuable to consumers when the retailer jointly provides special services at the point of sale. Such services might include information about selecting between different product models, information about how best to use the product, information about product warranties, information about credit terms, etc. By maintaining a low wholesale price while increasing the retail price (by increasing the ''retail margin''), the manufacturer can give its dealers' added incentive to invest in providing such services.

Absent RPM, and considering the transaction cost to the manufacturer of monitoring dealer-supplied services, any dealer who unilaterally invested in providing such services would be subject to free riding by other dealers selling the manufacturer's product. Consumers could go to the high-service, high-price dealer to learn about the product and then buy from the low-service, low-price dealer. Knowing the outcome of this prisoner's dilemma ex ante, no dealer would invest in providing special services, the manufacturer would lose sales to rival products, and consumers would suffer. In the years following Telser's contribution, several scholars have shown that RPM and other vertical restraints can be used to enhance dealers' incentives beyond the realm of point-of-sale service provision, including the incentive to promote product quality, ensure promotional efforts, engage in proper rotation of perishable goods, etc. (see, e.g., Klein and Murphy, 1988; Klein and Wright, 2007; Wright, 2007).

There can be little doubt cars are sufficiently complex products that consumers are best served by any number of jointly supplied promotional and quality control services dealers can effectively provide at the retail level. During the time when the conduct leading to the Honda case occurred, however, RPM was legally prohibited. This led manufacturers and their dealers to engage in any number of alternative arrangements to better serve consumers than simply leaving them to fend for themselves. One case in point is resort to Manufacturer Suggested Resale Prices (MSRP), but this was an imperfect mechanism owing to its murky legal status and manufactures' inability to effectively monitor dealers. The payment system relied on by Honda to compensate its marketing executives is a plausible way to overcome the deficiencies of the MSRP system.

Car manufacturers face a host of problems inducing their dealers to best serve the retail customer, and some dealers occasionally indulge in any number of failings such as too little promotion and underinvestment in learning enough about product attributes necessary to provide effective information to customers. If advertising and other local promotion by one dealer spills over to benefit neighboring

dealers, each dealer may free ride by under-providing local promotion, clearly a form of unethical rent seeking. The same is true for dealer sales-staff training and other service-related capital investments. Car dealers constitute a ''network'' in which inter-dealer spillovers must be ameliorated to provide optimal customer care.

The American Honda payment system overcame these deficiencies. With excess demand for many Honda and Acura models, dealers were free to raise the retail price well above the MSRP. American Honda could have responded by raising the wholesale price it charged its dealers, but it apparently did not want to do this, at least not fully. Dealers who were able to command sufficient allotments stood to earn an attractive retail margin on larger sales volume. But this, alone, did not ensure that dealers would provide the optimal levels of promotion and sales-staff training. In order to overcome this problem, American Honda apparently needed to give its own marketing executives high-powered incentives to encourage, monitor, police, influence, and cajole dealers into doing what it considered to be the right thing.

Allowing marketing executives to take a large portion of their compensation for inducing dealers to engage in local advertising and sales-staff training provided this incentive. In the language of the economics, the payment system made Honda marketing executives ''residual claimants'' to their success in doing so – i.e., they ''owned'' the consequences of their actions. Over time, the better they performed, the higher the retail price dealers could charge and the more dealers would be willing to ''pay'' for favorable allotments by agreeing to engage in advertising and training beneficial to the network. All else being equal, American Honda gained by achieving the optimal combination of increased sales and increased wholesale prices.

The compensation Honda marketing executives earned consisted of what economists refer to as a ''two-part tariff,'' which in essence unbundles the pricing of (and compensation for) different attributes of the executives' performance to reward them at the margin for their superior and more parsimonious effort incentivizing dealers and building the social capital of the dealer network. Executives that pushed higher value-added promotional programs on dealers to prevent free riding would have earned higher payments in the long run. Higher prices signal higher value-added in excess of the associated transaction costs. And favoring participating dealers with more generous allotments no doubt put more cars in possession of the dealers who had invested more in the dealer network to increase consumer demand. Since the opportunity to serve as a marketing executive was surely a competitive endeavor, those aspiring to these positions earned only a competitive expected wage – no unjust enrichment – just as American Honda asserted and the Court accepted.

The *ISCT* analysis of the Honda case DSR provide misses the mark on two counts. First, even assuming they are correct that the size of the non-participating dealer community was larger than the size of the participating community, their claim that the Honda payment system violated priority rule number three suffers from the problem I have already explained with majority rule. It fails to account for differences in the intensity of preferences across dealers. Mere numbers fail to tell the whole story. If the Honda payment system was an efficient form of organization designed to overcome dealers' maligned incentives, then the benefits to non-participating dealers must have fallen short of the benefits to customers, participating dealers, and American Honda – that is, the network as a whole.

Second, and related, if the payment system was efficient the inescapable conclusion is that it was ''essential to maintenance of the economic environment'' in which the parties transacted, thereby indicating it deserves priority over the norms of the nonparticipating dealers under rule number four.

At trial the defendants made several arguments. Even conceding that the payment system violated their contractual duty to determine dealer car allotments on a fair and reasonable basis, they claimed the dealer-plaintiffs lacked standing because they had suffered no injury causally connected to the payment system. The Court declined to accept the defendants standing argument in rejecting their motion to dismiss. The inference is that the defendants' argument leaves open a legitimate issue of fact whose legal disposition we will never know because they settled the case before going to trial.

Facing a statue such as RICO that has been repeatedly stretched well beyond its original intent, and which at the time was the source of substantial

legal uncertainty, I am reluctant to draw any ethical inference from he defendants' settlement. In my view, the plaintiffs' refusal to participate in sales-staff training and group advertising bodes poorly for them in a careful *ICST* analysis. Neither American Honda nor its marketing executives would have had anything obvious to gain from inducing dealer participation in these programs unless the programs benefited the entire network by increasing the appeal of Honda and Acura cars relative to rival brands.

One issue that would have arisen at a full trial on the merits, and that I consider relevant to an ethical analysis of the payment system, is whether plaintiffs suffered injury compared to the but-for world. This requires us to identify the next best alternative form of organization had the defendants declined to use the payment system. The most plausible alternative would have been for Honda to increase wholesale prices, raise marketing executives' standard compensation to competitive levels, and perhaps institute a system of more careful monitoring of dealer promotional and sales-staff training to which it tied dealer allotments in some way.

In this system, marketing executives would probably have earned some crude measure of "performance" compensation such as ad hoc bonuses or stock options that encouraged them to monitor dealers while steering clear of legal, and ethical, ambiguity. To the extent the alternative system was simply a wash, with no loss in efficiency, dealers would be no better or worse off because the increase in wholesale prices would exactly offset the reduction in the fees they paid for training and group advertising. The plaintiffs' assertion of injury, which boils down to a claim that the payment system distorted the distribution of income, is a red herring.

However, the alternative system would probably not provide a distributional wash, among other reasons because it would likely have increased the transaction costs American Honda and its dealers incurred to ensure proper marketing performance. Any credible claim to the contrary requires a showing that there are unique spillovers imposed on people outside the dealer network. This is because any spillovers within the dealer network would be internalized to the parties, who would have stood to profit by eliminating them. Within the network, American Honda would have every reason to adopt the system that minimized transaction costs to maximize consumers' willingness to pay for its cars. It would ultimately have to bear the losses from any failure in this regard through reduced dealer promotion and group advertising, reduced consumer demand, reduced revenue, and reduced wealth.

It is possible American Honda was simply mistaken as to the optimal form of organization. Perhaps marketing executives inevitably misbehaved because of their ability to accept tuition payments, Hong Kong shopping sprees, and other things of value from dealers with no strings attached regarding dealer promotion or group advertising to benefit the dealer network. Assuming the executives had an expectation of continued employment under the payment system, however, they would have suffered a reduction in the present value of future payment receipts as a result. If true, in any event, their receipt of pure perks would make out a claim for breach of fiduciary duty for which American Honda, and not nonparticipating dealers, would have been the aggrieved party.

Human beings are fallible, and people in all large-scale organizations routinely engage in idiosyncratic overreaching, shirking, and other misbehavior. This could account for some of the more troubling forms of payment the marketing executives are alleged to have taken. No system of organization can prevent that, and presumably business firms have every reason to eliminate it to the extent transaction costs permit. The question is whether the payment system on which American Honda relied to encourage dealer promotion and group advertising involved systematic misbehavior. Did it increase or decrease the commonwealth of consumers, dealers, and American Honda?

Concluding remarks and directions for future research

On the basis of the economics of transaction costs, as vetted and embraced by Antitrust courts and commentators, I believe I have made out a plausible case that Honda's dealer payment system was efficient. I am, therefore, unwilling to confer on it the label of "commercial bribery" without knowing much more about the facts. While it is true that the payment system conferred "a benefit on an employee, agent, or fiduciary with intent to influence the recipient's

conduct in his principal's affairs,'' it surely must be true that such conduct does not constitute commercial bribery where the principal consents to the practice. This is especially true where the benefit is in lieu of having to raise the agent's compensation and where the influence in question leads the agent to better serve the principal, the dealer network, and consumers.

My point in this article has not been to show that the dealer payment was necessarily efficient, only that it may plausibly have been efficient given the available facts and what we know about transaction cost economics. I also hope to suggest that *ISCT* can benefit from further refinements based on transaction cost economics. Given the depth and breadth of Antitrust scholarship and case law on vertical arrangements relying on transaction cost economics, this would seem to be a manageable and potentially informative project. I note that Antitrust, especially as applied to marketing practices, was one of Tom Dunfee's early interests, and I cannot help but think it influenced his thinking in developing his views on business ethics.

My hope in this article is that by more fully embracing economic analysis *ISCT* can help market participants resist the kind of rush to judgment we saw, for example, when Eliot Spitzer set about to resurrect New York's disquieting but quiescent Martin Act to bludgeon into submission firms whose commercial practices raised even an eyebrow. The sad consequence of the quick settlements Spitzer extracted is that we are left with little more than his allegations as evidence of what really happened.[8] Absent a reliable factual record, we will never know how the practices at issue would have fared under the dispassionate scrutiny of either *ISCT* or an adversarial legal proceeding.

In light of the opportunities and occasional tendencies politicians, attorneys general, interest groups, and private parties have for ethical rent seeking, I would like to suggest an important direction for future *ISCT* research. It would be extremely helpful to have an *ISCT* framework for assessing whether new statutes and regulations, as worded or as applied in any given setting, are ethical. It is hard to imagine, for example, that anyone thought when RICO was passed that it would be applied to the relationships between car manufacturers and their dealers. A fundamental value in liberal societies is that private parties should have notice of the conduct for which they face criminal or severe civil liability. To what extent do laws that are vague and, therefore, subject to shifting interpretation violate the social contract? One cannot presume that those who make or dispense law have the moral high ground.

Notes

[1] *U.S. v. Lopez*, 514 U.S. 549 (1995).

[2] Coase's ''The Problem of Social Cost'' (1960) is probably the most cited article in all of economics. His ''The Nature of the Firm'' (1937) is no doubt close behind. For an analysis relevant to commercial bribery see Coase (1979).

[3] My review is based on Tom's core works on *ISCT*, most notably his excellent book with Tom Donaldson (Donaldson and Dunfee, 1999), his various responses to critics (Dunfee, 2006), and Dunfee et al. (1999), in which he specifically addresses commercial bribery.

[4] A nonrivalrous good is one for which one person's use does not preclude another person's use. Network benefits occur when the benefit to any individual user increases the larger the number (or perhaps proportion) of other users in the system.

[5] Compared to transacting at a uniform price, for example, price discrimination redistributes the gains from trade between the parties.

[6] 941 F. Supp. 528 (1996).

[7] 127 S. Ct. 2705, 2723 (2007).

[8] A reliable but informal source tells me that there were only three criminal cases in which the defendants dared to litigate against Spitzer, and all three ended up with hung juries favoring acquittal 11 to 1. Personal communication with Jonathan Macey of Yale Law School.

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