Teaching Note

Whose Back do I Scratch?

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Critical Incident Overview

Danielle O'Reilly was frustrated. She paid for a massage but it seemed that she was not going to get it and that there was nothing she could do about it. Danielle refused to believe she paid thirty-five dollars for nothing, but what could she do? She paid The Good Life and they provided a coupon for a massage from Healing Hands ("HH"). Danielle wasn't having any luck convincing either one that she was entitled to her massage. She wondered who was responsible for making sure she got it? Who did she have the best chance of convincing that they should make sure she got it?

This critical incident is a descriptive incident. It asks students to examine a relatively common problem in internet sales: an intermediary sells coupons/vouchers for the services of a final provider. Students completing the analysis frame complaints based on different ethical approaches and are better prepared to engage in complaint behavior**.**

This critical incident would be useful in undergraduate courses focused on ethics, sales, internet marketing and business law.

Research Methods

The names of the companies and the principal actor in this critical incident are disguised. The critical incident is based on the notes and verbal account of one of the co-authors, who was the principal figure.

Learning Outcomes

In completing this assignment, students should be able to:

1. Apply Agency Theory to an intermediary relationship.
2. Determine the self-interests that drive the agent-principal problem.
3. Apply ethical frameworks to the agent-principal relationship.
4. Make recommendations for action that take into account the self-interests of agents and principals.
5. Determine the implications of moral hazard in an intermediary relationship.

Questions for Discussion

1. Who are the principals and agents in this problem? Draw out the principle-agent relationship(s). (LO 1)
2. Identify the different self-interests of the agents and principals. Determine the most appropriate ethical framework for each party. (LO 2 and LO 3)
3. Using the elements of self-interest identified in question 2, apply Equity Theory to determine the best course of action The Good Life can take in responding to Danielle? (LO 4)
4. Using the self-interests identified in question 2, what is HH's perspective? (LO 4)
5. What is the moral hazard in this situation? (LO 5)
6. Using the ethical frameworks developed for The Good Life and HH, how can Danielle best represent her self-interest to influence these two companies? (LO 3and LO 4)

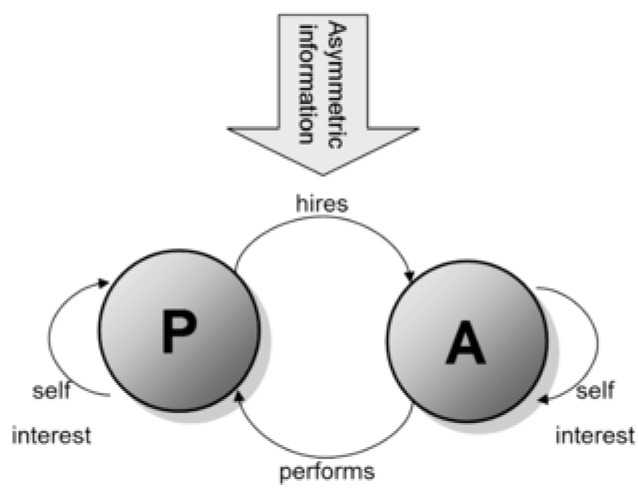
Answers to Discussion Questions

The critical incident represents an application of Agency Theory (Mitnick, 1973; Ross, 1973) in a modern-day intermediary relationship. Agency Theory seeks to explain the relationship between principals and agents and is concerned with resolving problems that can exist in these relationships. Agency theory addresses a variety of issues, but this critical incident focuses on problems which arise when the desires or goals of the principal and agent are in conflict. The critical incident asks students to examine the principal-agent relationship when problems arise under conditions of incomplete and asymmetric information when a principal hires an agent.

1. Who are the principals and agents in this problem? Draw out the principle-agent relationship(s). (LO 1)

Basic agency theory diagrams are similar to the Wikipedia diagram (2014) shown below:

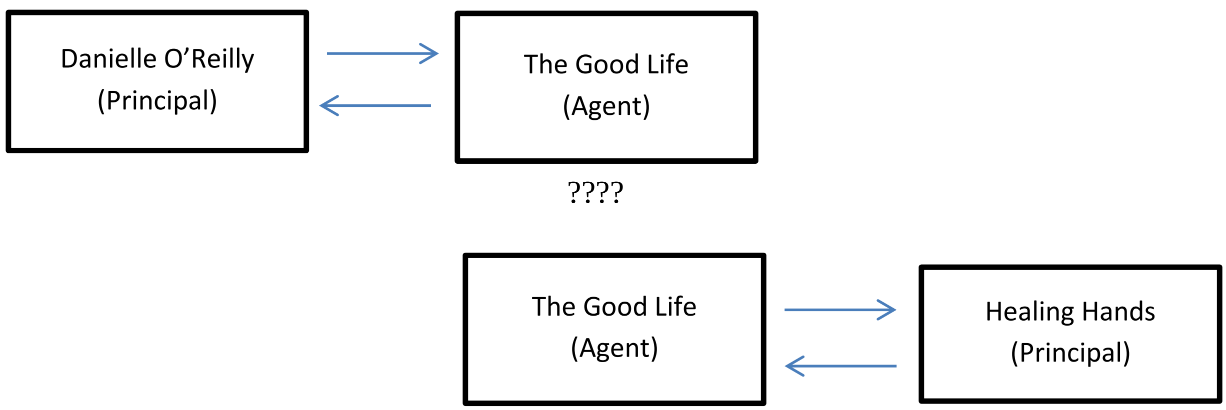
Figure 1 – Basic Idea of Agency Theory (Wikipedia)



Essentially, the principal hires the agent to perform some type of service because the principal either does not have access to or the expertise or the information that the agent does. In this critical incident, Danielle hires The Good Life because they provide access to discounted service coupons she cannot otherwise access. However, the relationship between The Good Life and HH appears to be similar in nature, The Good Life acts as an agent to HH in that The Good Life has access to a customer base HH does not. HH relies on The Good Life to disseminate marketing promotions on HH's behalf.

Students should draw a diagram similar to the one below to describe the principal-agent relationships of this critical incident:

Figure 2 – Principal-Agent Relationship with Intermediary



In effect, The Good Life serves as an agent for both Danielle and for HH. For students, the key at this stage of analysis is to recognize that something happens when the agents and principals represent different and overlapping interests. In this case, the intermediary serves as agent to both ends of the marketing promotion and has through their intermediary position opened themselves up to a potential for moral hazard (see Discussion Question 5).

2. Identify the different self-interests of the agents and principals. Determine the most appropriate ethical framework for each party. (LO 2 and LO 3)

Egoism is the doctrine that states that the motive(s) for human action can be best determined by self-interest, in other words, humans act the way they do so as to promote their own interests. Egoism can be a descriptive or a normative position with psychological egoism being the most famous descriptive position. Normative forms of egoism such as ethical egoism and rational egoism, strive to examine action based on what a person ought to do, rather than describe what that person does do (Shaver, 2010).

Psychological egoism, a descriptive position of egoism, states that human behavior has but one ultimate aim: for each person to promote their own welfare (Shaver, 2010). This position perhaps best describes Danielle's state of mind. She has paid for a service and wants to collect on that payment. Her core focus, at this point is to get her voice heard by either The Good Life or the provider, HH, to ensure she has her massage. Students are asked to further explain Danielle's position in question 6.

Rational egoism claims that an action must be rational for it to maximize one's self-interest (Shaver, 2010). Danielle's actions seem rational, she has paid for a service and wants to collect on her coupon. The Good Life's actions are also seemingly rational in that they have collected Danielle's money, issued her a coupon, ensured that HH and Danielle have taken up contact with each other, and (we presume) paid HH. HH's actions also appear rational, the masseuse service is busy and they are pushing a discounted client back as far as they can. It is to HH's best interest, the most rational approach, to handle higher paying clients first.

Normative egoism seeks to make claims about how individuals ought to behave, rather than to describe how individuals actually behave. A form of normative egoism, ethical egoism claims that the moral actor OUGHT to behave in their own self-interest; in effect, an actor is moral because they ought to act in their own self-interest. Ethical egoism differs from psychological egoism in that psychological egoism states the actions taken by each actor (principal and agent in this critical incident) exist solely to maximize their own welfare. In a way, ethical egoism serves to interject an element of introspection in the principal-agent relationship.

We encourage students to evaluate the self-interests of each party by examining each of four major ethical philosophies: Virtue Ethics, Teleology, Deontology, and Conventional Moral Rules.

<u>Virtue Ethics</u> poses the question, "What kind of person should I be in this situation?" Such virtues might include being merciful, steadfast, courageous, thoughtful, and loyal. Aristotle felt strongly that people should consciously develop their personal character to the point where any ethical decision could be made using these personal values as a guideline. To lead a good, happy and fulfilling life, each person needs to develop their own set of virtues. But, what are "virtues"? Webster's (1989) defines virtue as "a conformity to a standard of right; a particular moral excellence; and a commendable quality or trait." Dictionary.com (2015) states that virtue is "moral excellence; goodness; righteousness." The basic questions that come to mind when applying virtue ethics are: How are the virtues defined? What is the nature of the virtues? What is a virtuous act? Why are virtuous acts seen so differently across cultures? Danielle might ask herself out of which virtue she should act, what virtues should she use as guidelines to her interactions with The Good Life and HH. Students should realize that Virtue Ethics provide few if any clues on the self-interests of the principles and agents of the critical incident.

<u>Teleology</u> (Utilitarianism) holds that the moral rightness of an act should be judged based on its consequences (Mill, 2004). The notion of 'right' and 'wrong' is placed solely on the outcomes of an action. What will do the most good and the least harm? How do I weigh good vs. harm? Thus, it is ethical to promote what is seen as the greatest general good or greatest good for all.

Danielle probably feels that she has been "wronged," that HH's unresponsiveness is indicative of poor ethical behavior. In addition, The Good Life's slow response to her dilemma has created a further sense of being wronged. If Danielle chooses to tell all of her friends (or many other people) about the poor service of the two companies, she may be able to put pressure on these two companies to respond to the greater good. On the other hand, both companies probably feel that one complaint (from their point of view) does not make for a moral imperative to respond.

Teleology does not apply well to this critical incident, and students should recognize that this ethical framework provides little help in providing an explanation of self-interest (egoism).

Deontology (Ethics as Duty), or the theory of universal duty, finds its basis in Immanuel Kant's "categorical imperative (1785)." Kant believed that there were ethical duties which were universal and generalizable (i.e. would I want others to behave similarly?). One should follow such duties in all circumstances. Kant's categorical imperative (Kant, 1993 translation) implies that one should act in accordance with a universal law of nature which would be applicable to everyone making the same type of decision. In other words, if all people put in a similar situation chose a similar path of action, then that action would be considered morally correct. The action under consideration for The Good Life and HH is determining how to honor Danielle's coupon. For Danielle, the action is to determine how to communicate with the two companies so that they will understand her position, and respond to her request. The underlying rule(s) to this response are determined by whose point of view is taken:

- Danielle probably feels that both The Good Life and HH are duty-bound to provide either the massage, or her money back. Driven by her own self-interest, she wants one of these two outcomes to occur, with a preference toward getting the massage.
- HH is, to some extent, caught in the middle. While it is the final service provider, and thus ought to discharge this duty, it probably doesn't feel obligated towards fulfilling its duty to Danielle. If it were smart, HH would realize that it has a duty towards The Good Life, who has taken HH's word on good faith that the service will be delivered. HH's focus is on getting and keeping as many customers as it can, but appears to be having problems fitting everybody in.
- The Good Life is Danielle's agent so they SHOULD (ought to) feel a duty towards Danielle. Students must realize this element as they will need to explore this notion further in discussion question 3. While The Good Life might not recognize whether the duty is based in law or ethics, it should recognize that it does have a duty to Danielle. The Good Life is truly caught in the middle, as determined in question 1, since it is the de facto agent for both HH and Danielle. The Good Life's focus is on getting and keeping as many customers and providers as it can. Unfortunately, in this situation, it may have to sacrifice one to keep the other.

"Conventional Moral Rules (Social Contract) are the classic moral rules in each society that have stood the test of time (Wilhelm, 2006)." The rules are accepted and followed by many people mostly because they seem to create more benefit than cost. We use these rules in our day-to-day lives because they are accepted norms for behavior and because they do not require a great deal of calculation to determine the cost or benefit. The social contract is made up of a set of conventional moral rules that we as members of a society clearly accept and see as useful. Most of us don't consciously apply these rules, they are so deeply ingrained that we simply see the "right" way to do things at a nearly reflexive level.

In examining the social contract of this principal-agent relationship, students should provide the following logic, keeping in mind that discussion question 3 examines Equity Theory more fully:

- Danielle has paid for a service in good faith. Conventional moral rules in American society are that a customer who has paid for a service is due a service. In particular, most people would agree that once paid, a prepaid service should be delivered.

- The Good Life has accepted payment from Danielle for a service. Conventional moral rules, and American law, require The Good Life to ensure that Danielle receives the service that the The Good Life promised her.
- At some point, HH paid The Good Life to be included in their offerings and The Good Life included them with the understanding that HH would provide the advertised service. As a result, HH has a duty to The Good Life, but if HH truly has no openings, they may not understand the extent of that duty.
- Since HH has not accepted any money from Danielle, it may feel that it has very little duty towards her.

Rawls' (1971) Theory of Justice (or Justice as Fairness) examines the social contract by developing two principles of justice: the liberty principle and the difference principle. A part of the difference principle, Equity Theory seeks to determine satisfaction in terms of how people perceive fair/unfair distributions of resources within relationships, especially interpersonal relationships. Equity Theory examines Rawls' (1971) second principle of social justice, fair equality of opportunity, and serves as the basis to discussion question 3. Students should realize at this point of their analysis that Social Contract Theory, and in particular Equity Theory, probably provides the most guidance as to how the principles and agents of this critical incident use ethics to justify or explain their self-interests.

3. Using the elements of self-interest identified in question 2, apply Equity Theory to determine the best course of action The Good Life can take in responding to Danielle? (LO 4)

When developing an appropriate course of action for situations of service failure (which is exactly what happened to Danielle), firms should begin by understanding the importance of relationship development to their own success. Customers are the life-blood of an organization. Without (satisfied) customers, the firm will find it difficult to compete in the marketplace. Therefore, identifying an appropriate course of action involves a balancing act. On the one hand, the firm should be willing to take the necessary action to minimize the negativity associated with the failure. On the other hand, the firm should be concerned with not giving away the house, per se. Equity theory offers a theoretical explanation for this scenario.

Equity Theory (Adams, 1965) is commonly used to explain perceived satisfaction felt by parties involved in a relational exchange by comparing the ratio of inputs to outputs each party brings to the relationship. The underlying belief in this theory is that people value fairness in their relationships and are motivated to maintain equality based on what each party gives and receives.

When customers experience a service failure situation, the relationship no longer is considered equitable. From the customer's perspective, the ratio of inputs to outputs is no longer equivalent. Specifically, their inputs are more numerous than any benefits or outcomes. This inequity often leads to feelings of distress and/or anger followed by attempts to restore balance to their relationship. Customers may employ a variety of actions to increase their outputs. A common strategy customers use is to seek some compensation from their relationship partner.

Not all compensation offers will sufficiently satisfy the upset customer. Equity theory also suggests customers involved in disputes with firms base their perceptions of “justice” on three factors: distributive (what is given), procedural (fairness used to arrive at that decision), and interactional (how fairly the customer was treated throughout the ordeal). Thus, from the firm’s perspective, they should consider each of these when developing a policy or guidelines for how they (and their employees) respond to customer complaints.

The Good Life should at a minimum offer some type of apology to Danielle for their part in the unsatisfied delivery. In Danielle’s eyes, The Good Life was the direct recipient of her money. Thus, from Danielle’s perspective, The Good Life has not held up their part of the bargain. At a minimum, The Good Life should recognize their role in this particular exchange and take steps to ensure no additional harm is done. Failing to do so subjects them to additional criticism and potentially harmful word of mouth from Danielle to, at a minimum, her personal network.

The Good Life should recognize the potential of dealing with some bad apples (i.e. HH). However, The Good Life’s priority in this situation should be Danielle’s interest and ensuring that any dissatisfaction she may retain is not directed at them. A potential solution would be offering her a credit for her purchase and/or personally working with another vendor to ensure she receives the product she initially purchased. Rather than passing blame for the mishap on HH, taking appropriate action to ensure Danielle’s satisfaction should have a positive influence on her perception of The Good Life. In doing so, Danielle may be inclined to share her (unexpected) satisfaction (i.e. delight) with her network. This outcome would be a prime example of the service recovery paradox, which suggests that an effective recovery can turn an angry customer into a satisfied one. In some cases, the customer may even express greater satisfaction than if the failure and recovery situation had not occurred. Showing empathy to Danielle for her troubles and concern for her best interest will go a long way in making a positive impression of The Good Life. Treating her fairly (interactional justice), in a timely and effective manner (procedural justice), and offering her some appropriate compensation (distributive justice) in tandem are the most important things The Good Life can do.

4. **Using the self-interests identified in question 2, what is HH’s perspective? (LO 4)**

As stated in question 2, Kant’s categorical imperative (Kant, 1993 translation) implies that one should act in accordance with a universal law of nature which would be applicable to everyone making the same type of decision. In other words, if all people put in a similar situation chose a similar path of action, then that action would be considered morally correct. The steps used to determine whether an action is morally correct include (Livingstone, 2003) 1) defining the action under consideration, 2) deriving the underlying rule (maxim) for the action, and 3) testing the rule as a universal law.

Defining the Action. HH is trying to decide whether they can fit Danielle, a low-paying coupon customer, into their busy schedule. They want to stall Danielle as long as possible (the action they seem to prefer given the CI’s facts). HH does not want to honor it’s coupon in a timely fashion, which is rational given the fact that they are dealing with a discounted client.

Deriving the Underlying Rule. Push back coupon and low-paying purchasers in the scheduling system.

Testing the Rule as a Universal Law. HH's inaction reflects poorly on The Good Life; as such, as discussed in question 3, HH failed to deliver on their role as a relational partner; thus pushing back Danielle's appointment will not help build the business relationship. There is also an implied covenant of good faith and fair dealing which requires parties to a contract to act in good faith when fulfilling their obligations under the contract. In this principal-agent situation, fulfilling the contract would require that HH make good on their promise to The Good Life.

In turn, there is an implied social contract that when a coupon is sold, the provider should deliver on the purchase. On testing the rule in the world around us, the average person on the street would probably agree that delaying Danielle's appointment goes against good business practices. Overall, if most or all businesses behaved like HH did in this situation, companies like The Good Life would soon be out of business. More likely, if most or all companies behaved like HH, companies like The Good Life would cancel their business relationships.

While HH's perspective is easy to understand, being slow to schedule to low-paying clients is not a recommended course of action. Thus, from a deontological perspective we can safely say that HH has a duty to provide a massage.

5. What is the moral hazard in this situation? (LO 5)

Moral hazard occurs in relationships where one party is more apt to take risks because the cost of that risk is not borne by the party taking the risk (Kolb, 2008). Moral hazard is more likely to happen after a financial transaction has taken place and, thus, may arise in the principal-agent relationship where the principal pays for services up front, much like Danielle has paid up front for her massage coupon. The agent usually has more information than the principal and acts on this information creating a moral hazard known as the principal-agent problem. The agent may act in a manner that does not seem to make sense to the principal because the interests of the agent and principal are not fully aligned.

The Good Life is in a situation of moral hazard based on two perspectives: 1) as determined in question 1, The Good Life serves as an intermediary for two principals, yet Agency Theory indicates that The Good Life should serve as the agent of only one principal; and 2) since The Good Life has received payment for the transaction, they may no longer feel obligated to represent Danielle. Put simply, The Good Life may feel that HH has now taken responsibility for the process of delivering the service. They have information that Danielle does not, in this case HH may very well have delivered services on The Good Life coupons without issue in the past. The Good Life has pushed the responsibility of serving Danielle onto HH.

HH also faces moral hazard if they choose not to honor the coupon, or to delay honoring the coupon long enough, that they push Danielle to the point where she can not redeem the coupon. In turn, Danielle will complain to The Good Life, and while the Good Life may choose not to reimburse Danielle, The Good Life will eventually re-examine its relationship with HH if enough consumers complain. The moral hazard for HH comes into play the moment The Good Life chooses to change the nature of this principal-agent relationship and they risk generating this moment when they choose not to honor, or delay honoring, coupons.

6. **Using the ethical frameworks developed for The Good Life and HH, how can Danielle best represent her self-interest to influence these two companies? (LO 3 and LO 4)**

HH is a relatively new business in a service industry and its focus is on growing its customer base. It appears to have exceeded its expectations though and now finds itself with more demand for services than it can handle and scrambling to find ways to satisfy the additional demand. Danielle would do well to a) remind HH of their obligation to The Good Life; b) clarify that her point of view on delivering the massage is probably most people's point of view; and c) get confirmation that HH's calendar is indeed full. Students might suggest calling on a different phone line to schedule a massage, then presenting the coupon at the time of massage. While a rational approach, HH may not honor the coupon without prior knowledge since HH may want to schedule lower profit margin consumers at less busy hours. Danielle may find herself holding a coupon AND paying for a massage.

When interacting with The Good Life, Danielle should focus on: a) reminding The Good Life that while they may not feel ethically bound to help, they are duty-bound to represent the paying principal in this relationship, b) acknowledging that The Good Life is truly caught in the middle since they are the de facto agent for both HH and Danielle, however c) reinforcing that while The Good Life's focus is on getting and keeping as many customers and providers as it can, by duty and law paying principals must come first, and d) reminding The Good Life that delighting customers has a stronger long-term effect than angering providers.

Clearly, The Good Life's focus is on getting and keeping as many customers as it can, while also developing providers to service those customers. In this situation, The Good Life is caught in the middle of a dispute and Danielle must help them determine that it cannot satisfy both without alienating the other. She needs to appeal to them to ensure they honor their duty as her agent.

Note to Instructors

We opted to place Question 5 later in the analysis, asking students to build their ethical frameworks before engaging in complaint behavior. We have them look at the perspectives of all three parties before examining The Good life more narrowly. Given the course focus, asking question 5 earlier, as the second question, could lead to a different result in assessing the intermediary function of the The Good Life. Our core focus in this critical incident was to apply ethical frameworks to the agent-principal problem in order to develop complaint skills in students. Changing the discussion question sequence could allow the instructor to focus more on the intermediary function of The Good Life.

Epilogue

Danielle emailed The Good Life and told them that she hoped they could resolve this issue quickly. She also told that them that since she was in a law and ethics class, either way she would at least have some good material for class. She received an email back later that same day offering to apply her payment toward a massage with another masseuse. She took them up on their offer and got a massage from another masseuse. She never bought another gift certificate from The Good Life.

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