

# Conflict of Interest: What It Is, Its Causes and Consequences

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## ABSTRACT

*Given the persistent prevalence of conflict of interest in our society, the authors ask the question: What exactly is conflict of interest? Based on an extensive analysis of conflict of interest cases in the popular press, the authors come up with a typology of conflict of interest: personal conflict of interest versus organizational conflict of interest. Furthermore, the authors develop a model of the causes and reactions to conflict of interest. The authors identify four antecedents to conflict of interest which include delegation of authority, guanxi and guanxi practice, law and ethics code, and moral & values. At the same time, the authors find that the characteristics of conflict of interest, which include network strength, exchange value, and transparency will influence people's reactions to the conflict of interest and perception of impaired judgment and decision making.*

**Keywords:** *CEO Compensation, Conflict of Interest, Corporate Governance, Ethics, Guanxi, Procedural Justice, Social Networks*

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## INTRODUCTION

Ever since Enron's case in October 2001, there has been much more attention paid to corporate scandals. One outstanding theme that has emerged from the corporate scandals is the conflict of interest issue. There are numerous large and famous companies that have been involved in conflict of interest issues, for example, Arthur Andersen in accounting,

Merrill Lynch, Morgan Stanley and Citigroup in investment banking, and Enron, WorldCom, Tyco, and Global Crossing in other industries.

Not only is conflict of interest prominent in the corporate world, it also has tainted government and much of the world beyond. People involved in conflict of interest charges include former US secretaries of state Henry Kissinger and George Shultz, former US CIA director James Woolsey, Bush Administration's Iraq policy architect Richard Perle, and United

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States Olympic Committee (USOC) chief executive Lloyd Ward.

The purpose of this study is three-fold. First, we seek to understand the construct of conflict of interest. What exactly is conflict of interest? Is the concept as straightforward as it sounds? Second, we will attempt to come up with a typology of conflicts of interest. Third, we will analyze the reports collected to find out what factors cause or control the tendency to engage in conflict of interest, and what people's reactions are to it.

The paper is organized as follows. The first section defines and clarifies the concept of conflict of interest. The second section gives a typology of conflict of interest. The third section develops a model of what are the causes and reactions to conflict of interest and its characteristics.

## WHAT IS CONFLICT OF INTEREST?

What do people refer to when they talk about conflict of interest? The makeup of the term makes conflict of interest seem a pretty straightforward concept to most people: which means having interests that conflict. People's ordinary picture of a conflict of interest is one in which some personal or financial relationship external to one's position makes it difficult for one to perform the duties of one's position (Carson, 1994). This is shown by the following examples of conflict of interest as used by people in common discourse:

*During the years, Wall Street firms wore a number of conflicting hats for Enron, serving as an underwriter on Enron stock and bond deals, and often providing positive research on the company's stock. ... Investigators want to know if such conflicts of interest hindered Wall Street's ability to call attention to Enron's problems sooner. (Gasparion & Hamburger, 2002) During one hearing of the House committee on financial services, legislators focused on the conflicts of interest that riddle the credit rat-*

*ings industry, not the least of which is the fact that the main players receive the bulk of their revenues by collecting ratings and consulting fees from the very companies whose debt they evaluate. (Revell, 2003)*

*'I am concerned about recent press reports that senior executives (at Premier and Novation, two big hospital buying groups who serve as purchasing agents for hospitals) have received or obtained stock or stock options from product suppliers, creating serious conflicts of interest,' Orrin Hatch, Republican of Utah, said in a statement at the hearing. (Meier & Walsh, 2002) Charles Elsoon, director of the Center for Corporate Governance at the University of Delaware, said it is a conflict of interest for an outside director to also serve as an investment banker on a particular transaction, because his personal interest in getting paid may not coincide with the interests of Tyco shareholders. (Maremont, 2002)*

Although it seems that people have a pretty good intuitive sense of conflict of interest, the notion of conflict of interest is much more sophisticated. Therefore, we need to give a more precise definition for conflict of interest. In this article we adopt the definition of conflict of interest given by (Davis & Stark, 2001):

*A conflict of interest is a situation in which some person (whether an individual or corporate body) stands in a certain relation to one or more decisions. On the standard view, P has a conflict of interest if, and only if (1) P is in a relationship with another requiring P to exercise judgment in the other's behalf and (2) P has a (special) interest tending to interfere with the proper exercise of judgment in that relationship.*

In the above definition, it is important to realize that the crucial terms are "situation", "decision", and "relationship". These are the key elements that constitute conflict of interest:

1. **Conflict of Interest is a Situation:** A conflict of interest refers to a situation that

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