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BUSINESS LAW *and the* REGULATION *of* BUSINESS

RICHARD A. MANN
BARRY S. ROBERTS

Ethical Dilemma

Business Law in Action

Going Global

Applying the Law

Concept Review

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THIRTEENTH EDITION

BUSINESS LAW *and the* REGULATION *of* BUSINESS

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Preface

The Tradition Continues

The thirteenth edition of *Business Law and the Regulation of Business* continues the tradition of accuracy, comprehensiveness, and authoritativeness associated with its earlier editions. This text covers its subject material in a succinct, nontechnical but authoritative manner, and provides depth sufficient to ensure easy comprehension by today's students.

Topical Coverage

This text is designed for use in business law and legal environment of business courses generally offered in universities, colleges, and schools of business and management. Because of its broad and deep coverage, this text may be readily adapted to specially designed courses in business law or the legal environment of business by assigning and emphasizing different combinations of chapters.

Certified Public Accountant Preparation

As updated effective January 1, 2019, the Uniform CPA Examination is composed of four sections: Auditing and Attestation (AUD), Business Environment and Concepts (BEC), Financial Accounting and Reporting (FAR), and Regulation (REG). This textbook covers material included in Area II (Business Law) of the Regulation section of the CPA Exam. See the inside back cover of this text for a listing of the CPA exam topics covered in this text as well as the chapters covering each topic.

In general, Area II of the REG section blueprint covers several topics of Business Law, including the following:

- Knowledge and understanding of the legal implications of business transactions, particularly as they relate to accounting, auditing, and financial reporting
- Areas of agency, contracts, debtor–creditor relationships, government regulation of business, and business structure
  - The Uniform Commercial Code under the topics of contracts and debtor-creditor relationships
  - Nontax-related business structure content
  - Federal and widely adopted uniform state laws and references as identified in [the following] References
    - Revised Model Business Corporation Act
    - Revised Uniform Limited Partnership Act
    - Revised Uniform Partnership Act
    - Securities Act of 1933
    - Securities Exchange Act of 1934
    - Uniform Commercial Code
    - Current textbooks covering business law

More specifically, Area II of the REG section blueprint includes the following topics, which are covered in this textbook:

II. Business Law

- **A.** Agency
  - **1.** Authority of agents and principals
  - **2.** Duties and liabilities of agents and principals
- **B.** Contracts
  - **1.** Formation
  - **2.** Performance
  - **3.** Discharge, breach, and remedies
- **C.** Debtor–Creditor Relationships
  - **1.** Rights, duties, and liabilities of debtors, creditors, and guarantors
  - **2.** Bankruptcy and insolvency
  - **3.** Secured transactions
- **D.** Government Regulation of Business
  - **1.** Federal securities regulation
  - **2.** Other federal laws and regulations
- **E.** Business Structure
  - **1.** Selection and formation of business entity and related operation and termination
  - **2.** Rights, duties, legal obligations, and authority of owners and management

For more information, visit https://www.aicpa.org/becomeacpa/cpaexam.html.

Business Ethics Emphasis

The text highlights how ethics applies to business. The Business Ethics case studies in Chapter 2 require students to make the value trade-offs that confront businesspeople in their professional lives. (We gratefully acknowledge the assistance of James Leis in writing the Mykon's Dilemma case.) Two-thirds of the chapters also contain an Ethical Dilemma, which presents a managerial situation involving ethical issues. A series of questions leads students to explore the ethical dimensions of each situation. We wish to acknowledge and thank the following professors for their contributions in preparing the Ethical Dilemmas: Sandra K. Miller, professor of accounting, taxation, and business law, Widener University, and Gregory P. Cermignano, associate professor of accounting and business law, Widener University. In addition, to provide further application of ethics in different business contexts, an ethics question follows many cases. These questions are designed to encourage students to consider the ethical dimensions of the facts in the case or of the legal issue invoked by the facts.

New to This Edition

Updated and Expanded Coverage

The new edition has been extensively updated and includes coverage of

- The new Restatement (Third) of Torts: Liability for Economic Harm in Chapters 7, 8, 11, 18, and 43
- Low-profit limited liability companies (L3Cs) in Chapter 32
- The 2016 Revised Model Business Corporation Act in Chapters 33–36
- The U.S. Securities and Exchange Commission's new Regulation Crowdfunding and intrastate exemptions as well as the 2017 amendments to Rules 147 and 504 in Chapter 39
- The Defend Trades Secrets Act of 2016 and the 2016 amendments to the Economic Espionage Act in Chapter 40
- The Consumer Review Fairness Act of 2016 in Chapter 44
- The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 in Chapters 44 and 49
- The 2016 amendments to the Toxic Substances Control Act in Chapter 45

New Cases

Approximately twenty recent legal cases are new to this edition (see Table of Cases). The new cases include recent U.S. Supreme Court decisions such as *DIRECTV, Inc. v. Imburgia; Shaw v. United States; Husky International Electronics, Inc., v. Ritz; Young v. United Parcel Service, Inc.; Salmon v. United States; and OBB Personenverkehr Ag v. Sachs*.

Coverage of Recent U.S. Supreme Court Decisions

The Constitutional Law chapter (Chapter 4) covers the Supreme Court decisions holding that the anticommandeering doctrine invalidated a federal statute that prohibited states from authorizing sports gambling schemes, that Internet retailers can be required to collect sales taxes in states where they have no physical presence, and that public employees who choose not to join unions may not be required to help pay for collective bargaining. The Criminal Law chapter (Chapter 6) covers the Supreme Court decision holding that the government must obtain a search warrant to access wireless carriers' historical cell-site records revealing the location of a user's cell phone whenever it made or received calls. The Bankruptcy Law chapter (Chapter 38) discusses the Supreme Court decision holding that in Chapter 11 cases, including structured dismissal cases, a bankruptcy court cannot confirm a plan that contains distributions that violate the priority rules over the objection of an impaired creditor class. The Securities Regulation chapter (Chapter 39) discusses the Supreme Court decision holding that under the Securities Litigation Uniform Standards Act of 1998, state courts have jurisdiction over class actions alleging violations of only the 1933 Act and defendants are not permitted to remove such actions from state court to federal court. The Intellectual Property chapter (Chapter 40) covers Supreme Court cases involving the patent exhaustion doctrine, the disparagement clause of the Lanham Act, and the constitutionality of *inter partes* review. The Employment Law chapter (Chapter 41) discusses the Supreme Court decisions holding that nonunionized private-sector employers may enforce employment agreements that require employees to settle employment disputes through individual arbitration rather than in class or collective actions and that public employees who choose not to join unions may not be required to help pay for collective bargaining. The International Law chapter (Chapter 46) covers the Supreme Court decision holding that lost foreign profits may be recovered for patent infringement involving components of a patented invention shipped

overseas to be assembled there. The Trusts and Wills Chapter (Chapter 50) covers the Supreme Court decision holding that the retroactive application of Minnesota's revocation-upon-divorce statute, which automatically nullifies the designation of an ex-spouse as the beneficiary of a life insurance policy or other will substitute, does not violate the Contracts Clause of the U.S. Constitution.

Key Features

Excerpted Cases
Relevant, carefully selected, and interesting cases illustrate how key principles of business law are applied in the United States. All of the cases have the facts and decisions summarized for clarity and the opinions edited to preserve the language of the court. Each case is followed by an interpretation, which explains the significance of the case and how it relates to the textual material. We have retained the landmark cases from the prior edition. In addition, we have added approximately twenty recent cases, including a number of U.S. Supreme Court cases.

Case Critical Thinking Questions
Each case is also followed by a critical thinking question to encourage students to examine the legal policy or reasoning behind the legal principle of the case or to apply it in a real-world context.

Ample Illustrations
We have incorporated more than 220 classroom-tested figures, tables, diagrams, concept reviews, and chapter summaries. The figures, tables, and diagrams help students conceptualize the many abstract concepts in the law. The Concept Reviews not only summarize prior discussions but also indicate relationships between different legal rules. Moreover, each chapter ends with a summary in the form of an annotated outline of the entire chapter, including key terms.

Applying the Law
The "Applying the Law" feature provides a systematic legal analysis of a realistic situation that focuses on a single concept presented in the chapter. It begins with the facts of a hypothetical case, followed by an identification of the broad legal issue presented by those facts. We then state the rule—or applicable legal principles, including definitions, which aid in resolving the legal issue—and apply it to the facts. Finally, we state a legal conclusion or decision in the case. The Applying the Law feature appears in fourteen chapters. We wish to acknowledge and thank Professor Ann Olazábal, University of Miami, for her contribution in preparing this feature.

Business Law in Action
The "Business Law in Action" scenarios illustrate the application of legal concepts in the chapter to business situations that commonly arise. This feature provides students meaningful insights into how managers currently apply the law within common workplace situations. There are twenty-seven scenarios in all. We wish to acknowledge and thank Professor Ann Olazábal, University of Miami, for her contribution in preparing this feature.

Practical Advice
Each chapter has a number of statements that illustrate how legal concepts covered in that chapter can be applied to common business situations.

Going Global
A "Going Global" feature appears in fifteen chapters (Chapters 1, 3, 6, 9, 15, 19, 20, 27, 30, 34, 38, 39, 40, 41, and 42), thus integrating international business law content throughout the text. This feature enables students to consider the international aspects of legal issues as they are covered. The International Business Law chapter (Chapter 46) has been retained in its entirety.

Chapter Outcomes
Each chapter begins with a list of learning objectives for students.

Enhanced Readability
To improve readability throughout the text, all unnecessary "legalese" has been eliminated, while necessary legal terms have been printed in boldface and clearly defined, explained, and illustrated. Each chapter is carefully organized with sufficient levels of subordination to enhance the accessibility of the material. The text is enriched by numerous illustrative hypothetical and case examples that help students relate material to real-life experiences.

Classroom-Proven End-of-Chapter Materials
Classroom-proven questions and case problems appear at the end of the chapters to test students' understanding of major concepts. We have used the questions (based

on hypothetical situations) and the case problems (taken from reported court decisions) in our own classrooms and consider them excellent stimulants to classroom discussion. Students, in turn, have found the questions and case problems helpful in enabling them to apply the basic rules of law to factual situations.

Taking Sides

Each chapter—except Chapters 1 and 2—has an end-of-chapter feature that requires students to apply critical thinking skills to a case-based fact situation. Students are asked to identify the relevant legal rules and develop arguments for both parties to the dispute. In addition, students are asked to explain how they think a court would resolve the dispute.

Pedagogical Benefits

Classroom use and study of this book should provide students with the following benefits and skills:

1. Perception and appreciation of the scope, extent, and importance of the law.
2. Basic knowledge of the fundamental concepts, principles, and rules of law that apply to business transactions.
3. Knowledge of the function and operation of courts and government administrative agencies.
4. Ability to recognize the potential legal problems that may arise in a doubtful or complicated situation and the necessity of consulting a lawyer and obtaining competent professional legal advice.
5. Development of analytical skills and reasoning power.

Additional Course Tools

MindTap

MindTap is a personalized teaching experience with relevant assignments that guide students to analyze, apply, and improve thinking, allowing instructors to measure skills and outcomes with ease. Teaching becomes personalized through a pre-built Learning Path designed with key student objectives and the instructor syllabus in mind. Applicable reading, multimedia, and activities within the learning path intuitively guide students up the levels of learning to (1) Prepare, (2) Engage, (3) Apply, and (4) Analyze business law content. These activities are organized in a logical progression to help elevate learning, promote critical-thinking skills, and produce better outcomes.

This customizable online course gives instructors the ability to add their own content in the Learning Path as well as modify authoritative Cengage content and learning tools using apps that integrate seamlessly with Learning Management Systems (LMS). Analytics and reports provide a snapshot of class progress, time in course, engagement, and completion rates.

Instructor's Resources

Instructors can access these resources by going to **login.cengage.com**, logging in with a faculty account username and password, and searching 9780357042526.

- The **Instructor's Manual** prepared by Richard A. Mann, Barry S. Roberts, and Beth D. Woods contains chapter outlines; teaching notes; answers to the Questions, Case Problems, and Taking Sides; and part openers that provide suggested research and outside activities for students.
- **PowerPoint® Slides** clarify course content and guide student note-taking during lectures.
- The **Test Bank** contains thousands of true/false, multiple-choice, and essay questions. The questions vary in levels of difficulty and meet a full range of tagging requirements so that instructors can tailor their testing to meet their specific needs.
- **Cengage Testing Powered by Cognero** is a flexible, online system that allows you to
  - author, edit, and manage test bank content from multiple Cengage solutions
  - create multiple test versions in an instant
  - deliver tests from your Learning Management Systems (LMS), your classroom, or wherever you want

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Richard A. Mann

Barry S. Roberts

Part I

Introduction to Law and Ethics

Chapter 1

Introduction to Law

The life of the law has not been logic; it has been experience.
Oliver Wendell Holmes *The Common Law* (1881)

Chapter Outcomes

After reading and studying this chapter, you should be able to:

1. Identify and describe the basic functions of law.
2. Distinguish between (a) law and justice and (b) law and morals.
3. Distinguish between (a) substantive and procedural law, (b) public and private law, and (c) civil and criminal law.
4. Identify and describe the sources of law.
5. Explain the principle of *stare decisis*.

Law concerns the relations between individuals as such relations affect the social and economic order. It is both the product of civilization and the means by which civilization is maintained. As such, law reflects the social, economic, political, religious, and moral philosophy of society.

Law is an instrument of social control. Its function is to regulate, within certain limitations, human conduct and human relations. Accordingly, the laws of the United States affect the life of every U.S. citizen. At the same time, the laws of each state influence the life of each of its citizens and the lives of many noncitizens as well. The rights and duties of all individuals, as well as the safety and security of all people and their property, depend on the law.

The law is pervasive. It permits, forbids, or regulates practically every human activity and affects all persons either directly or indirectly. Law is, in part, prohibitory: certain acts must not be committed. For example, one must not steal; one must not murder. Law is also partly mandatory: certain acts must be done or be done in a prescribed way. Thus, taxes must be paid; corporations must make and file certain reports with state or federal authorities; traffic must keep to the right. Finally, law is permissive: certain acts may be done. For instance, one may or may not enter into a contract; one may or may not dispose of one's estate by will.

Because the areas of law are so highly interrelated, you will find it helpful to begin the study of the different areas of business law by first considering the nature, classification, and sources of law. This will enable you not only to understand each specific area of law better but also to understand its relationship to other areas of law.

Nature of Law [1-1]

The law has evolved slowly, and it will continue to change. It is not a pure science based on unchanging and universal truths. Rather, it results from a continuous striving to develop a workable set of rules that balance the individual and group rights of a society.

Definition of Law [1-1a]

Scholars and citizens in general often ask a fundamental but difficult question regarding law: what is it? Numerous philosophers and jurists (legal scholars) have attempted to define it. American jurists and Supreme Court Justices Oliver Wendell Holmes and Benjamin Cardozo defined law as predictions of the way in which a court will decide specific legal questions. The English jurist William Blackstone, on the other hand, defined law as "a rule of civil conduct prescribed by the supreme power in a state, commanding what is right, and prohibiting what is wrong."

Because of its great complexity, many legal scholars have attempted to explain the law by outlining its essential characteristics. Roscoe Pound, a distinguished American jurist and former dean of the Harvard Law School, described law as having multiple meanings:

> First we may mean the legal order, that is, the régime of ordering human activities and relations through systematic application of the force of politically organized society, or through social pressure in such a society backed by such force. We use the term "law" in this sense when we speak of "respect for law" or for the "end of law."
>
> Second we may mean the aggregate of laws or legal precepts; the body of authoritative grounds of judicial and administrative action established in such a society. We may mean the body of received and established materials on which judicial and administrative determinations proceed. We use the term in this sense when we speak of "systems of law" or of "justice according to law."
>
> Third we may mean what Justice Cardozo has happily styled "the judicial process." We may mean the process of determining controversies, whether as it actually takes place, or as the public, the jurists, and the practitioners in the courts hold it ought to take place.

Functions of Law [1-1b]

At a general level, the primary **function of law** is to maintain stability in the social, political, and economic system while simultaneously permitting change. The law accomplishes this basic function by performing a number of specific functions, among them dispute resolution, protection of property, and preservation of the state.

Disputes, which arise inevitably in any modern society, may involve criminal matters, such as theft, or noncriminal matters, such as an automobile accident. Because disputes threaten social stability, the law has established an elaborate and evolving set of rules to resolve them. In addition, the legal system has instituted societal remedies, usually administered by the courts, in place of private remedies such as revenge.

A second crucial function of law is to protect the private ownership of property and to assist in the making of voluntary agreements (called contracts) regarding exchanges of property and services. Accordingly, a significant portion of law, as well as this text, involves property and its disposition, including the law of property, contracts, sales, commercial paper, and business associations.

A third essential function of the law is preservation of the state. In our system, law ensures that changes in political structure and leadership are brought about by political action, such as elections, legislation, and referenda, rather than by revolution, sedition, and rebellion.

Law and Morals [1-1c]

Although moral concepts greatly influence the law, morals and law are not the same. You might think of them as two intersecting circles (see Figure 1-1). The area common to both circles includes the vast body of ideas that are both moral and legal. For instance, "Thou shall not kill" and "Thou shall not steal" are both moral precepts and legal constraints.

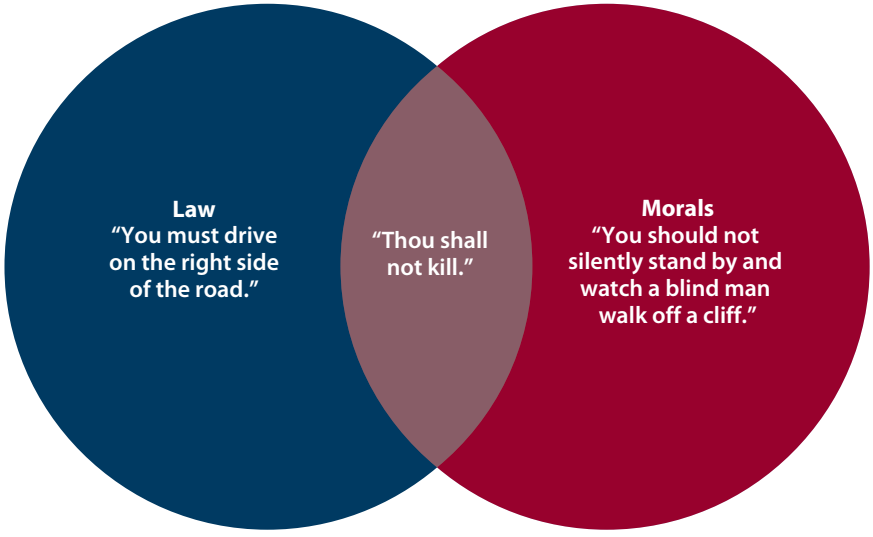
On the other hand, the part of the legal circle that does not intersect the morality circle includes many rules of law that are completely unrelated to morals, such as the rules stating that you must drive on the right side of the road and that you must register before you can vote. Likewise, the part of the morality circle that does not intersect the legal circle includes moral precepts not enforced by legal sanctions, such as the idea that you should not silently stand by and watch a blind man walk off a cliff or that you should provide food to a starving child.

Law and Justice [1-1d]

Law and justice represent separate and distinct concepts. Without law, however, there can be no justice. Although defining justice is at least as difficult as defining law, justice generally may be defined as the fair, equitable, and impartial treatment of the competing interests and desires of individuals and groups with due regard for the common good.

On the other hand, law is no guarantee of justice. Some of history's most monstrous acts have been committed pursuant to "law." Examples include the actions

FIGURE 1-1 *Law and Morals*



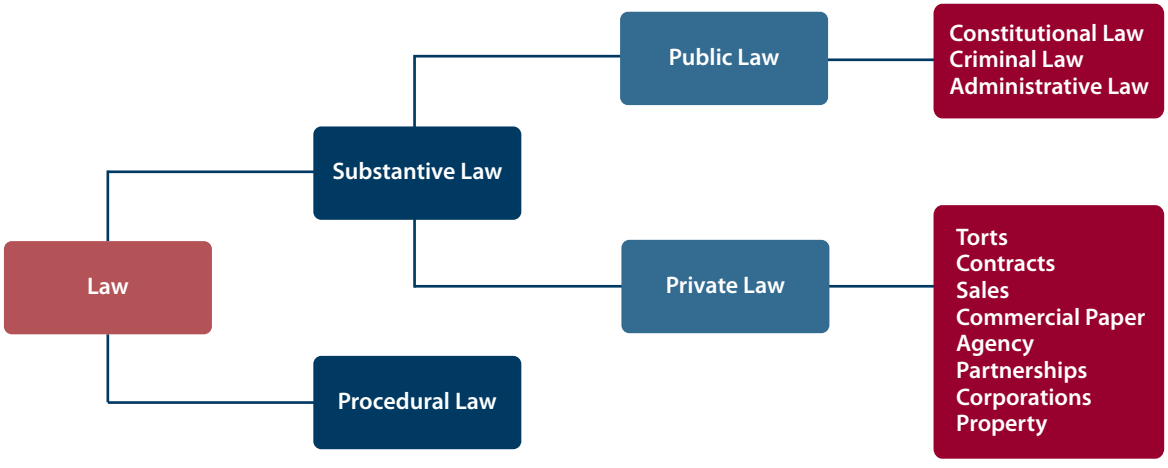
of Nazi Germany during the 1930s and 1940s and the actions of the South African government under apartheid from 1948 until 1994. Totalitarian societies often have shaped formal legal systems around the atrocities they have sanctioned.

CLASSIFICATION OF LAW [1-2]

Because the subject is vast, classifying the law into categories is helpful. Though a number of categories are possible, the most useful ones are (1) substantive and procedural, (2) public and private, and (3) civil and criminal. See Figure 1-2, which illustrates a classification of law.

Basic to understanding these classifications are the terms *right* and *duty*. A **right** is the capacity of a person, with the aid of the law, to require another person or persons to perform, or to refrain from performing, a certain act. Thus, if Alice sells and delivers goods to Bob for the agreed price of $500 payable at a certain date, Alice is capable, with the aid of the courts, of enforcing the payment by Bob of the $500. A **duty** is the obligation the law imposes upon a person to perform, or to refrain from performing, a certain act. Duty and right are correlatives: no right can rest upon one person without a corresponding duty resting upon some other person, or in some cases upon all other persons.

FIGURE 1-2 *Classification of Law*



CONCEPT REVIEW 1-1

Comparison of Civil and Criminal Law

	Civil Law	Criminal Law
Commencement of Action	Aggrieved individual (plaintiff) sues	State or federal government prosecutes
Purpose	Compensation Deterrence	Punishment Deterrence Rehabilitation Preservation of peace
Burden of Proof	Preponderance of the evidence	Beyond a reasonable doubt
Principal Sanctions	Monetary damages Equitable remedies	Capital punishment Imprisonment Fines

Substantive and Procedural Law [1-2a]

Substantive law creates, defines, and regulates legal rights and duties. Thus, the rules of contract law that determine a binding contract are rules of substantive law. On the other hand, **procedural law** sets forth the rules for enforcing those rights that exist by reason of the substantive law. Thus, procedural law defines the method by which to obtain a remedy in court.

Public and Private Law [1-2b]

Public law is the branch of substantive law that deals with the government's rights and powers and its relationship to individuals or groups. Public law consists of constitutional, administrative, and criminal law. **Private law** is that part of substantive law governing individuals and legal entities (such as corporations) in their relationships with one another. Business law is primarily private law.

Civil and Criminal Law [1-2c]

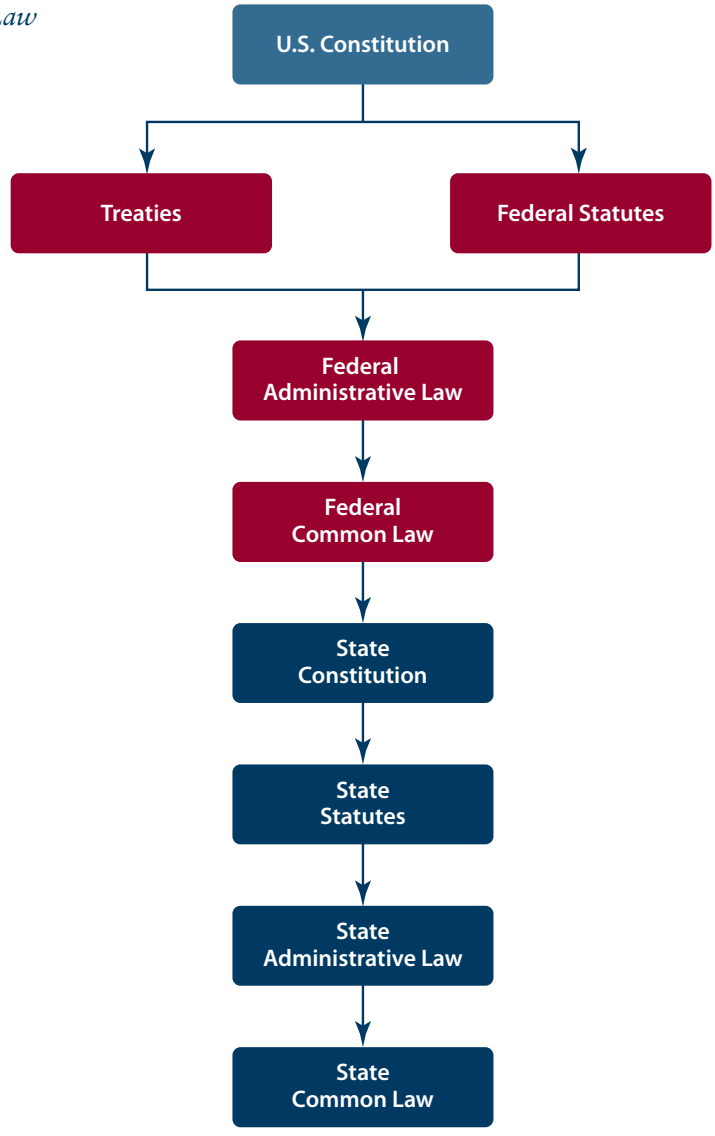
The **civil law** defines duties, the violation of which constitutes a wrong against the party injured by the violation. In contrast, the **criminal law** establishes duties, the violation of which is a wrong against the whole community. Civil law is a part of private law, whereas criminal law is a part of public law. (The term *civil law* should be distinguished from the concept of a civil law *system*, which is discussed later in this chapter.) In a civil action the injured party **sues** to recover *compensation* for the damage and injury sustained as a result of the **defendant's** wrongful conduct. The party bringing a civil action (the **plaintiff**) has the burden of proof, which the plaintiff must sustain by a *preponderance* (greater weight) *of the evidence*. The purpose of the civil law is to compensate the injured party, not, as in the case of criminal law, to punish the wrongdoer. The principal forms of relief the civil law affords are a judgment for money damages and a decree ordering the defendant to perform a specified act or to desist from specified conduct.

A crime is any act prohibited or omission required by public law in the interest of protecting the public and made punishable by the government in a judicial proceeding brought (**prosecuted**) by it. The government must prove criminal guilt *beyond a reasonable doubt*, which is a significantly higher burden of proof than that required in a civil action. Crimes are prohibited and punished on the grounds of public policy, which may include the safeguarding of government, human life, or private property. Additional purposes of criminal law include deterrence and rehabilitation. See Concept Review 1-1 for a comparison of civil and criminal law.

Sources of Law [1-3]

The sources of law in the U.S. legal system are the federal and state constitutions, federal treaties, interstate compacts, federal and state statutes and executive orders, the ordinances of countless local municipal governments, the rules and regulations of federal and state administrative agencies, and an ever-increasing volume of reported federal and state court decisions.

FIGURE 1-3 *Hierarchy of Law*



The ***supreme law*** of the land is the U.S. Constitution, which provides in turn that federal statutes and treaties shall be paramount to state constitutions and statutes. Federal legislation is of great significance as a source of law. Other federal actions having the force of law are executive orders by the President and rules and regulations set by federal administrative officials, agencies, and commissions. The federal courts also contribute considerably to the body of law in the United States.

The same pattern exists in every state. The paramount law of each state is contained in its written constitution. (Although a state constitution cannot deprive citizens of federal constitutional rights, it can guarantee rights beyond those provided in the U.S. Constitution.) State constitutions tend to be more specific than the U.S. Constitution and, generally, have been amended more frequently. Subordinate to the state constitution are the statutes enacted by the state's legislature and the case law developed by its judiciary. Likewise, rules and regulations of state administrative agencies have the force of law, as do executive orders issued by the governors of most states. In addition, cities, towns, and villages have limited legislative powers to pass ordinances and resolutions within their respective municipal areas. See Figure 1-3, which illustrates this hierarchy.

Constitutional Law [1-3a]

A **constitution**—the fundamental law of a particular level of government—establishes the governmental structure and allocates power among governmental levels, thereby defining political relationships. One of the fundamental principles on which our government is founded is that of separation of powers. As incorporated into the U.S. Constitution, this means that government consists of three distinct and independent branches—the federal judiciary, the Congress, and the executive branch.

A constitution also restricts the powers of government and specifies the rights and liberties of the people. For example, the Constitution of the United States not only specifically states what rights and authority are vested in the national government but also specifically enumerates certain rights and liberties of the people. Moreover, the Ninth Amendment to the U.S. Constitution makes it clear that this enumeration of rights does not in any way deny or limit other rights that the people retain.

All other law in the United States is subordinate to the federal Constitution. No law, federal or state, is valid if it violates the federal Constitution. Under the principle of **judicial review**, the Supreme Court of the United States determines the constitutionality of *all* laws.

Judicial Law [1-3b]

The U.S. legal system, a **common law system** like the system first developed in England, relies heavily on the judiciary as a source of law and on the adversary system for settling disputes. In an **adversary system**, the parties, not the court, must initiate and conduct litigation. This approach is based on the belief that the truth is more likely to emerge from the investigation and presentation of evidence by two opposing parties, both motivated by self-interest, than from judicial investigation motivated only by official duty. In addition to the United States (except Louisiana) and England, the common law system is used in other countries previously colonized by England, including Canada (except Quebec), Australia, and New Zealand.

In distinct contrast to the common law system are civil law systems, which are based on Roman law. **Civil law systems** depend on comprehensive legislative enactments (called codes) and an inquisitorial system of determining disputes. In the **inquisitorial system**, the judiciary initiates litigation, investigates pertinent facts, and conducts the presentation of evidence. The civil law system prevails in most of Europe, Scotland, the state of Louisiana, the province of Quebec, Latin America, and parts of Africa and Asia.

Common Law The courts in common law systems have developed a body of law that serves as precedent for determining later controversies. In this sense, common law, also called case law or judge-made law, is distinguished from other sources of law, such as legislation and administrative rulings.

To evolve in a stable and predictable manner, the common law has developed by application of *stare decisis* ("to stand by the decisions"). Under the principle of ***stare decisis***, courts adhere to and rely on rules of law that they or superior courts relied on and applied in prior similar decisions. Judicial decisions thus have two uses: (1) to determine with finality the case currently being decided and (2) to indicate how the court will decide similar cases in the future. *Stare decisis* does not, however, preclude courts from correcting erroneous decisions or from choosing among conflicting precedents. Thus, the doctrine allows sufficient flexibility for the common law to change. The strength of the common law is its ability to adapt to change without losing its sense of direction.

Equity As the common law developed in England, it became overly rigid and beset with technicalities. As a consequence, in many cases no remedies were provided because the judges insisted that a claim must fall within one of the recognized forms of action. Moreover, courts of common law could provide only limited remedies; the principal type of relief obtainable was a monetary judgment. Consequently, individuals who could not obtain adequate relief from monetary awards began to petition the king directly for justice. He, in turn, came to delegate these petitions to his chancellor.

Gradually, there evolved what was in effect a new and supplementary system of needed judicial relief for those who could not receive adequate remedies through the common law. This new system, called **equity**, was administered by a court of chancery presided over by the chancellor. The chancellor, deciding cases on "equity and good conscience," regularly provided relief where common law judges had refused to act or where the remedy at law was inadequate. Thus, there grew up, side by side, two systems of law administered by different tribunals, the common law courts and the courts of equity.

An important difference between common law and equity is that the chancellor could issue a **decree**, or order, compelling a defendant to do, or refrain from doing, a specified act. A defendant who did not comply with this order could be held in contempt of court and punished by fine or imprisonment. This power of compulsion available in a court of equity opened the door to many needed remedies not available in a court of common law.

CONCEPT REVIEW 1-2

Comparison of Law and Equity

	Law	Equity
Availability	Generally	Discretionary: if remedy at law is inadequate
Precedents	*Stare decisis*	Equitable maxims
Jury	If either party demands	None, in federal and almost all states
Remedies	Judgment for monetary damages	Decree of specific performance, injunction, reformation, rescission

Courts of equity in some cases recognized rights that were enforceable at common law, but they provided more effective remedies. For example, in a court of equity, for breach of a land contract the buyer could obtain a decree of **specific performance** commanding the defendant seller to perform his part of the contract by transferring title to the land. Another powerful and effective remedy available only in the courts of equity was the **injunction**, a court order requiring a party to do or refrain from doing a specified act. Another remedy not available elsewhere was **reformation**, where, upon the ground of mutual mistake, an action could be brought to reform or change the language of a written agreement to conform to the actual intention of the contracting parties. An action for **rescission** of a contract, which allowed a party to invalidate a contract under certain circumstances, was another remedy.

Although courts of equity provided remedies not available in courts of law, they granted such remedies only at their discretion, not as a matter of right. This discretion was exercised according to the general legal principles, or **maxims**, formulated by equity courts over the years.

In nearly every jurisdiction in the United States, courts of common law and equity have merged into a single court that administers both systems of law. Vestiges of the old division remain, however. For example, the right to a trial by jury applies only to actions at law, but not, under federal law and in almost every state, to suits filed in equity.

See Concept Review 1-2 for a comparison of law and equity.

Restatements of Law The common law of the United States results from the independent decisions of the state and federal courts. The rapid increase in the number of decisions by these courts led to the establishment of the American Law Institute (ALI) in 1923. The ALI is composed of a distinguished group of lawyers, judges, and law professors who set out to prepare

> an orderly restatement of the general common law of the United States, including in that term not only the law developed solely by judicial decision, but also the law that has grown from the application by the courts of statutes that were generally enacted and were in force for many years.

As set out in its charter, the ALI's mission is to "to promote the clarification and simplification of the law and its better adaptation to social needs, to secure the better administration of justice, and to encourage and carry on scholarly and scientific legal work." The ALI is limited to 3,000 elected members in addition to ex officio members and life members, for a total membership of nearly 4,600.

Regarded as the authoritative statement of the common law of the United States, the Restatements cover many important areas of the common law, including torts, contracts, agency, property, and trusts. Although not law in themselves, they are highly persuasive, and courts frequently have used them to support their opinions. Because they provide a concise and clear statement of much of the common law, relevant portions of the Restatements are relied on frequently in this book.

Legislative Law [1-3c]

Since the end of the nineteenth century, legislation has become the primary source of new law and ordered social change in the United States. The annual volume of legislative law is enormous. Justice Felix Frankfurter's remarks to the New York City Bar in 1947 are even more appropriate in the twenty-first century:

> Inevitably the work of the Supreme Court reflects the great shift in the center of gravity of law-making. Broadly speaking, the number of cases disposed of by opinions has not changed

> from term to term. But even as late as 1875 more than 40 percent of the controversies before the Court were common-law litigation, fifty years later only 5 percent, while today cases not resting on statutes are reduced almost to zero. It is therefore accurate to say that courts have ceased to be the primary makers of law in the sense in which they "legislated" the common law. It is certainly true of the Supreme Court that almost every case has a statute at its heart or close to it.

This emphasis on legislative or statutory law has occurred because common law, which develops evolutionarily and haphazardly, is not well suited for making drastic or comprehensive changes. Moreover, while courts tend to be hesitant about overruling prior decisions, legislatures commonly repeal prior enactments. In addition, legislatures may choose the issues they wish to address, whereas courts may deal only with those issues presented by actual cases. As a result, legislatures are better equipped to make the dramatic, sweeping, and relatively rapid changes in the law that technological, social, and economic innovations compel.

While some business law topics, such as contracts, agency, property, and trusts, still are governed principally by the common law, most areas of commercial law, including partnerships, corporations, sales, commercial paper, secured transactions, insurance, securities regulation, antitrust, and bankruptcy, have become largely statutory. Because most states enacted their own statutes dealing with these branches of commercial law, a great diversity developed among the states and hampered the conduct of commerce on a national scale. The increased need for greater uniformity led to the development of a number of proposed uniform laws that would reduce the conflicts among state laws.

The most successful example is the ***Uniform Commercial Code (UCC)***, which was prepared under the joint sponsorship and direction of the ALI and the Uniform Law Commission (ULC), which is also known as the National Conference of Commissioners on Uniform State Laws (NCCUSL). All fifty states (although Louisiana has adopted only Articles 1, 3, 4, 5, 7, and 8), the District of Columbia, and the Virgin Islands have adopted the UCC.

Established in 1892, the ULC is comprised of more than 300 lawyers, judges, and law professors appointed by each state. It has drafted more than three hundred uniform laws for the states to consider and enact. The ULC also promulgates a "model" act when an act's principal purposes can be substantially achieved even if the act is not adopted in its entirety by every state. Its most widely adopted acts include the Uniform Partnership Act, the Uniform Limited Partnership Act, the Uniform Electronic Transactions Act, the Uniform Trade Secrets Act, and the Uniform Probate Code.

The ALI has developed a number of model statutory formulations, including the Model Code of Evidence, the Model Penal Code, and a Model Land Development Code. In addition, the American Bar Association has promulgated the Model Business Corporation Act.

Treaties A **treaty** is an agreement between or among independent nations. The U.S. Constitution authorizes the President to enter into treaties with the advice and consent of the Senate, "providing two thirds of the Senators present concur."

Treaties may be entered into only by the federal government, not by the states. A treaty signed by the President and approved by the Senate has the legal force of a federal statute. Accordingly, a federal treaty may supersede a prior federal statute, while a federal statute may supersede a prior treaty. Like statutes, treaties are subordinate to the federal Constitution and subject to judicial review.

Going Global

What is the WTO?

Nations have entered into bilateral and multilateral treaties to facilitate and regulate trade and to protect their national interests. Probably the most important multilateral trade treaty is the General Agreement on Tariffs and Trade (GATT), which the *World Trade Organization (WTO)* replaced as an international organization. The WTO officially commenced on January 1, 1995, and has at least 164 members, including the United States, accounting for more than 98 percent of world trade. (More than twenty countries are observers and are seeking membership.) Its basic purpose is to facilitate the flow of trade by establishing agreements on potential trade barriers, such as import quotas, customs, export regulations, antidumping restrictions (the prohibition against selling goods for less than their fair market value), subsidies, and import fees. The WTO administers trade agreements, acts as a forum for trade negotiations, handles trade disputes, monitors national trade policies, and provides technical assistance and training for developing countries.

Executive Orders In addition to the executive functions, the President of the United States also has authority to issue laws, which are called **executive orders**. This authority typically derives from specific delegation by federal legislation. An executive order may amend, revoke, or supersede a prior executive order. An example of an executive order is the one issued by President Johnson in 1965 prohibiting discrimination by federal contractors on the basis of race, color, sex, religion, or national origin in employment on any work the contractor performed during the period of the federal contract.

The governors of most states enjoy comparable authority to issue executive orders. Depending on the state, the authority for governors to issue executive orders comes from state constitutions, statutes, or case law.

Administrative Law [1-3d]

Administrative law is the branch of public law that is created by administrative agencies in the form of rules, regulations, orders, and decisions to carry out the regulatory powers and duties of those agencies. It also deals with controversies arising among individuals and these public officials and agencies. Administrative functions and activities concern general matters of public health, safety, and welfare, including the establishment and maintenance of military forces, police, citizenship and naturalization, taxation, environmental protection, and the regulation of transportation, interstate highways, waterways, television, radio, and trade and commerce.

Because of the increasing complexity of the nation's social, economic, and industrial life, the scope of administrative law has expanded enormously. In 1952 Justice Jackson stated, "the rise of administrative bodies has been the most significant legal trend of the last century, and perhaps more values today are affected by their decisions than by those of all the courts, review of administrative decisions apart." This is evidenced by the great increase in the number and activities of federal government boards, commissions, and other agencies. Certainly, agencies create more legal rules and decide more controversies than all the legislatures and courts combined.

Legal Analysis [1-4]

Decisions in state trial courts generally are not reported or published. The precedent a trial court sets is not sufficiently weighty to warrant permanent reporting. Except in New York and a few other states where selected opinions of trial courts are published, decisions in trial courts are simply filed in the office of the clerk of the court, where they are available for public inspection. Decisions of state courts of appeals are published in consecutively numbered volumes called "reports." In most states, court decisions are found in the official state reports of that state. In addition, state reports are published by West Publishing Company in a regional reporter called the National Reporter System, composed of the following: Atlantic (A., A.2d, or A.3d); South Eastern (S.E. or S.E.2d); South Western (S.W., S.W.2d, or S.W.3d); New York Supplement (N.Y.S. or N.Y.S.2d); North Western (N.W. or N.W.2d); North Eastern (N.E. or N.E.2d); Southern (So., So.2d, or So.3d); Pacific (P., P.2d, or P.3d); and California Reporter (Cal.Rptr., Cal.Rptr.2d, or Cal. Rptr.3d). At least twenty states no longer publish official reports and have designated a commercial reporter as the authoritative source of state case law.

After they are published, these opinions, or "cases," are referred to ("cited") by giving (1) the name of the case; (2) the volume, name, and page of the official state report, if any, in which it is published; (3) the volume, name, and page of the particular set and series of the National Reporter System; and (4) the volume, name, and page of any other selected case series. For instance, *Lefkowitz v. Great Minneapolis Surplus Store, Inc.*, 251 Minn. 188, 86 N.W.2d 689 (1957), indicates that the opinion in this case may be found in Volume 251 of the official Minnesota Reports at page 188 and in Volume 86 of the North Western Reporter, Second Series, at page 689, and that the opinion was delivered in 1957.

The decisions of courts in the federal system are found in a number of reports. U.S. District Court opinions appear in the Federal Supplement (F.Supp. or F.Supp.2d). Decisions of the U.S. Court of Appeals are found in the Federal Reporter (Fed., F.2d, or F.3d), and the U.S. Supreme Court's opinions are published in the U.S. Supreme Court Reports (U.S.), Supreme Court Reporter (S.Ct.), and Lawyers Edition (L.Ed.). While all U.S. Supreme Court decisions are reported, not every case decided by the U.S. District Courts and the U.S. Courts of Appeals is reported. Each circuit has established rules determining which decisions are published.

In reading the title of a case, such as "*Jones v. Brown*," the "v." or "vs." means versus or against. In the trial court, Jones is the ***plaintiff***, the person who filed the suit, and Brown is the ***defendant***, the person against whom the suit was brought. When the case is appealed, some, but not all, courts of appeals or appellate courts place the name of the party who appeals, or the **appellant**, first, so that "*Jones v. Brown*" in the trial court becomes, if Brown loses and hence becomes the appellant, "*Brown v. Jones*" in the appellate court. Therefore, it is not always possible to determine from the title itself who was the plaintiff and who was the defendant. You must carefully

read the facts of each case and clearly identify each party in your mind to understand the discussion by the appellate court. In a criminal case the caption in the trial court will first designate the prosecuting government unit and then will indicate the defendant, as in "*State v. Jones*" or "*Commonwealth v. Brown*."

The study of reported cases requires an understanding and application of legal analysis. Normally, the reported opinion in a case sets forth (1) the essential facts, the nature of the action, the parties, what happened to bring about the controversy, what happened in the lower court, and what pleadings are material to the issues; (2) the issues of law or fact; (3) the legal principles involved; (4) the application of these principles; and (5) the decision.

A serviceable method of analyzing and briefing cases after a careful reading and comprehension of the opinion is for students to write in their own language a brief containing the following:

1. the facts of the case
2. the issue or question involved
3. the decision of the court
4. the reasons for the decision

The following excerpt from Professor Karl Llewellyn's *The Bramble Bush* contains a number of useful suggestions for reading cases:

> The first thing to do with an opinion, then, is read it. The next thing is to get clear the actual decision, the judgment rendered. Who won, the plaintiff or defendant? And watch your step here. You are after in first instance the plaintiff and defendant *below*, in the trial court. In order to follow through what happened you must therefore first know the outcome below; else you do not see what was appealed from, nor by whom. You now follow through in order to see exactly what *further* judgment has been rendered on appeal. The stage is then clear of form—although of course you do not yet know all that these forms mean, that they imply. You can turn now to what you want peculiarly to know. Given the actual judgments below and above as your indispensable framework—what has the case decided, and what can you derive from it as to what will be decided later?
>
> You will be looking, in the opinion, or in the preliminary matter plus the opinion, for the following: a statement of the facts the court assumes; a statement of the precise way the question has come before the court— which includes what the plaintiff wanted below, and what the defendant did about it, the judgement below, and what the trial court did that is complained of; then the outcome on appeal, the judgment; and, finally the reasons this court gives for doing what it did. This does not look so bad. But it is much worse than it looks.
>
> For all our cases are decided, all our opinions are written, all our predictions, all our arguments are made, on certain four assumptions. They are the first presuppositions of our study. They must be rutted into you till you can juggle with them standing on your head and in your sleep.
>
> 1. *The court must decide the dispute that is before* it. It cannot refuse because the job is hard, or dubious, or dangerous.
> 2. *The court can decide only the particular dispute which is before it*. When it speaks to that question it speaks *ex cathedra*, with authority, with finality, with an almost magic power. When it speaks to the question before it, it announces *law*, and if what it announces is new, it legislates, it *makes* the law. But when it speaks to any other question at all, it says mere words, which no man needs to follow. Are such words worthless? They are not. We know them as judicial *dicta*; when they are wholly off the point at issue we call them *obiter dicta*—words dropped along the road, wayside remarks. Yet even wayside remarks shed light on the remarker. They may be very useful in the future to him, or to us. But he will not feel bound to them, as to his *ex cathedra* utterance. They came not hallowed by a Delphic frenzy. He may be slow to change them; but not so slow as in the other case.
> 3. *The court can decide the particular dispute only according to a general rule which covers a whole class of like disputes*. Our legal theory does not admit of single decisions standing on their own. If judges are free, are indeed forced, to decide new cases for which there is no rule, they must at least make a new rule as they decide. So far, good. But how wide, or how narrow, is the general rule in this particular case? That is a troublesome matter. The practice of our case-law, however, is I think fairly stated thus: it pays to be suspicious of general rules which look too wide; it pays to go slow in feeling *certain* that a wide rule has been laid down at all, or that, if seemingly laid down, it will be followed. For there is a fourth accepted canon:
> 4. *Everything, everything, everything, big or small, a judge may say in an opinion, is to be read with primary reference to the particular dispute, the particular question before him.* You are not to think that the words mean what they might if they stood alone. You are to have your eye on the case in hand, and to learn how to interpret all that has been said *merely* as a reason for deciding *that* case *that* way.

By way of example, the following edited case of *Caldwell v. Bechtel, Inc*. is presented and then briefed using Llewellyn's suggested format. (Note: The cases in the rest of this text have their facts and decision summarized for the reader's convenience. The edited portion of the case begins with the judge's name.)

Caldwell v. Bechtel, Inc.

United States Court of Appeals, District of Columbia Circuit, 1980
631 F.2d 989

OPINION MacKinnon, J. We are here concerned with a claim for damages by a worker who allegedly contracted silicosis while he was mucking in a tunnel under construction as part of the metropolitan subway system (Washington Metropolitan Area Transit Authority [WMATA]). The basic issue is whether a consultant engineering firm owed the worker a duty to protect him against unreasonable risk of harm.

***

In attempting to convince the court that it owes no duty of reasonable care to protect appellant's safety, Bechtel argues that by its contract with WMATA it assumed duties only to WMATA. Appellant has not brought action, however, for breach of contract but rather seeks damages for an asserted breach of the duty of reasonable care. Unlike contractual duties, which are imposed by agreement of the parties to a contract, a duty of due care under tort law is based primarily upon social policy. The law imposes upon individuals certain expectations of conduct, such as the expectancy that their actions will not cause foreseeable injury to another. These societal expectations, as formed through the common law, comprise the concept of duty.

Society's expectations, and the concomitant duties imposed, vary in response to the activity engaged in by the defendant. If defendant is driving a car, he will be held to exercise the degree of care normally exercised by a reasonable person in like circumstances. Or if defendant is engaged in the practice of his profession, he will be held to exercise a degree of care consistent with his superior knowledge and skill. Hence, when defendant Bechtel engaged in consulting engineering services, the company was required to observe a standard of care ordinarily adhered to by one providing such services, possessing such skill and expertise.

A secondary but equally important principle involved in a determination of duty is to whom the duty is owed. The answer to this question is usually framed in terms of the foreseeable plaintiff, in other words, one who might foreseeably be injured by defendant's conduct. This secondary principle also serves to distinguish tort law from contract law. While in contract law, only one to whom the contract specifies that a duty be rendered will have a cause of action for its breach, in tort law, society, not the contract, specifies to whom the duty is owed, and this has traditionally been the foreseeable plaintiff.

It is important to keep these differences between contract and tort duties in mind when examining whether Bechtel's undertaking of contractual duties to WMATA created a duty of reasonable care toward Caldwell. Dean Prosser [a leading legal scholar on tort law] expressed the relationship in this terse fashion.

[B]y entering into a contract with A, the defendant may place himself in such a relation toward B that the law will impose upon him an obligation, sounding in tort and not in contract, to act in such a way that B will not be injured. The incidental fact of the existence of the contract with A does not negat[e] the responsibility of the actor when he enters upon a course of affirmative conduct which may be expected to affect the interests of another person.

***

Analyzing the common law, Prosser noted that courts have found a duty to act for the protection of another when certain relationships exist, such as carrier-passenger, innkeeper-guest, shipper-seaman, employer-employee, shopkeeper-visitor, host-social guest, jailer-prisoner, and school-pupil. These holdings suggest that courts have been eroding the general rule that there is no duty to act to help another in distress, by creating exceptions based upon a relationship between the actors.

***

We find that case law provides many such analogous situations from which the principles deserving of application to this case may be culled. The foregoing concepts of duty converge in this case, as the facts include both the WMATA-Bechtel contractual relationship from which it was foreseeable that a negligent undertaking by Bechtel might injure the appellant, and a special relationship established between Bechtel and the appellant because of Bechtel's superior skills, knowledge of the dangerous condition, and ability to protect appellant. ***

***

We reverse the summary judgment of the district court, and hold that as a matter of law, on the record as we are required to view it at this time, Bechtel owed Caldwell a duty of due care to take reasonable steps to protect him from the foreseeable risk of harm to his health posed by the excessive concentration of silica dust in the Metro tunnels. We remand so that Caldwell will have an opportunity to prove, if he can, the other elements of his negligence action.

Brief of Caldwell v. Bechtel, Inc.

FACTS Caldwell was a laborer who now suffers from silicosis. He claims that he contracted the disease while working in a tunnel under construction as part of the Washington Metropolitan Area Transportation Authority (WMATA). He brought his action for damages against Bechtel, Inc., a consultant engineering firm under contract with WMATA for the project.

ISSUE Did Bechtel breach a duty of due care owed to Caldwell to take reasonable steps to protect him from the foreseeable risk of harm to his health posed by the excessive concentration of silica dust in the subway tunnels?

DECISION In favor of Caldwell. Summary judgment reversed and case remanded to the district court.

REASONS Caldwell has not brought an action for breach of contract as Bechtel seems to believe. Rather, he seeks damages for an alleged breach of the duty of reasonable care. Unlike contractual duties, which are imposed by agreement of the parties to a contract, a duty of due care under tort law is based primarily on social policy. That is, the law imposes upon individuals the expectation that their actions will not cause foreseeable injury to another. These societal expectations comprise the concept of duty—a concept that varies in response to the activity engaged in by the individual. Moreover, the duty is owed to anyone who might foreseeably be injured by the conduct of the actor in question. In contrast, under contract law, a duty is owed only to those parties specified in the contract. Here, by entering into a contract with WMATA, Bechtel placed itself in such a relation toward Caldwell that the law will impose upon it an obligation in tort, and not in contract, to act in such a way that Caldwell would not be injured.

You can and should use this same legal analysis when learning the substantive concepts presented in this text and applying them to the end-of-chapter questions and case problems. By way of example, in a number of chapters throughout the text, we have included a boxed feature called "Applying the Law," which provides a systematic legal analysis of a single concept learned in the chapter. This feature begins with the **facts** of a hypothetical case, followed by an identification of the broad legal **issue** presented by those facts. We then state the ***rule of law***—the applicable legal principles, including definitions, which aid in resolving the legal issue—and ***apply*** it to the facts. Finally, we state a legal **conclusion**, or decision in the case. An example of this type of legal analysis appears on the previous page.

Applying the Law

Introduction to Law

Facts Jackson bought a new car and planned to sell his old one for about $2,500. But before he did so, he happened to receive a call from his cousin, Trina, who had just graduated from college. Among other things, Trina told Jackson she needed a car but did not have much money. Feeling generous, Jackson told Trina he would give her his old car. But the next day a coworker offered Jackson $3,500 for his old car, and Jackson sold it to the coworker.

Issue Did Jackson have the right to sell his car to the coworker, or legally had he already made a gift of it to Trina?

Rule of Law A gift is the transfer of ownership of property from one person to another without anything in return. The person making the gift is called the donor, and the person receiving it is known as the donee. A valid gift requires (1) the donor's present intent to transfer the property and (2) delivery of the property.

Application In this case, Jackson is the would-be donor and Trina is the would-be donee. To find that Jackson had already made a gift of the car to Trina, both Jackson's intent to give it to her and delivery of the car to Trina would need to be demonstrated. It is evident from their telephone conversation that Jackson did intend at that point to give the car to Trina. It is equally apparent from his conduct that he later changed his mind, because he sold it to someone else the next day. Consequently, he did not deliver the car to Trina.

Conclusion Because the donor did not deliver the property to the donee, legally no gift was made. Jackson was free to sell the car.

Chapter Summary

Nature of Law

Definition of Law "a rule of civil conduct prescribed by the supreme power in a state, commanding what is right, and prohibiting what is wrong" (William Blackstone)

Functions of Law to maintain stability in the social, political, and economic system through dispute resolution, protection of property, and the preservation of the state, while simultaneously permitting ordered change

Laws and Morals are different but overlapping; law provides sanctions while morals do not

Law and Justice are separate and distinct concepts; justice is the fair, equitable, and impartial treatment of competing interests with due regard for the common good

Classification of Law

Substantive and Procedural
- *Substantive Law* law creating rights and duties
- *Procedural Law* rules for enforcing substantive law

Public and Private
- *Public Law* law dealing with the relationship between government and individuals
- *Private Law* law governing the relationships among individuals and legal entities

Civil and Criminal
- *Civil Law* law dealing with rights and duties, the violation of which constitutes a wrong against an individual or other legal entity
- *Criminal Law* law establishing duties that, if violated, constitute a wrong against the entire community

Sources of Law

Constitutional Law fundamental law of a government establishing its powers and limitations

Judicial Law
- *Common Law* body of law developed by the courts that serves as precedent for determination of later controversies
- *Equity* body of law based upon principles distinct from common law and providing remedies not available at law

Legislative Law statutes adopted by legislative bodies
- *Treaties* agreements between or among independent nations
- *Executive Orders* laws issued by the President or by the governor of a state

Administrative Law law created by administrative agencies in the form of rules, regulations, orders, and decisions to carry out the regulatory powers and duties of those agencies

Chapter 2

Business Ethics

Our characters are the result of our conduct.

Aristotle, *Nicomachean Ethics* (c. 335 bce)

Chapter Outcomes

After reading and studying this chapter, you should be able to:

1. Describe the difference between law and ethics.
2. Compare the various ethical theories.
3. Describe cost-benefit analysis and explain when it should be used and when it should be avoided.
4. Explain Kohlberg's stages of moral development.
5. Explain the ethical responsibilities of business.

Business ethics is a subset of ethics: no special set of ethical principles applies only to the world of business. Immoral acts are immoral, whether or not a businessperson has committed them. In the last few years, countless business wrongs, such as insider trading, fraudulent earnings statements and other accounting misconduct, price-fixing, concealment of dangerous defects in products, reckless lending and improper foreclosures in the housing market, and bribery, have been reported almost daily. Companies such as Enron, WorldCom, Adelphia, Parmalat, Arthur Andersen, and Global Crossing have violated the law, and some of these firms no longer exist as a result of these ethical lapses. In 2004, Martha Stewart was convicted of obstructing justice and lying to investigators about a stock sale. More recently, Bernie Madoff perpetrated the largest Ponzi scheme in history with an estimated loss of $20 billion in principal and approximately $65 billion in paper losses. In May 2011, Galleon Group (a hedge fund) billionaire Raj Rajaratnam was found guilty of fourteen counts of conspiracy and securities fraud. In 2013, large international banks faced a widening scandal—and substantial fines—over attempts to rig benchmark interest rates, including the London Interbank Offered Rate (LIBOR).

Ethics can be defined broadly as the study of what is right or good for human beings. It attempts to determine what people ought to do, or what goals they should pursue. **Business ethics**, as a branch of applied ethics, is the study and determination of what is right and good in business settings. Business ethics seeks to understand the moral issues that arise from business practices, institutions, and decision making, and their relationship to generalized human values. Unlike legal analyses, analyses of ethics have no central authority, such as courts or legislatures, upon which to rely, nor do they follow clear-cut universal standards. Nonetheless, despite these inherent limitations, it still may be possible to make meaningful ethical judgments. To improve ethical decision making, it is important to understand how others have approached the task.

Some examples of the many business ethics questions may clarify the definition of business ethics. In the employment relationship, countless ethical issues arise regarding the safety and compensation of workers, their civil rights (such as equal treatment, privacy, and freedom from sexual harassment), and the legitimacy of whistleblowing. In the relationship between business and its customers, ethical issues permeate marketing techniques, product safety, and consumer protection. The relationship between business and its owners bristles with ethical questions involving corporate governance, shareholder voting, and management's duties to the shareholders. The relationship among competing businesses involves numerous ethical matters, including fair competition and the effects of collusion. The interaction between business and society at large presents additional ethical dimensions: pollution of the physical environment, commitment to the community's economic and social infrastructure, and depletion of natural resources. Not only do all of these issues recur at the international level, but additional ones present themselves, such as bribery of foreign officials, exploitation of developing countries, and conflicts among differing cultures and value systems.

In resolving the ethical issues raised by business conduct, it is helpful to use a ***seeing-knowing-doing*** model. First, the decision maker should ***see*** (identify) the ethical issues involved in the proposed conduct, including the ethical implications of the various available options. Second, the decision maker should ***know*** (resolve) what to do by choosing the best option. Finally, the decision maker should ***do*** (implement) the chosen option by developing and implementing strategies.

This chapter first surveys the most prominent ethical theories (the knowing part of the decision, on which the great majority of philosophers and ethicists have focused). The chapter then examines ethical standards in business and the ethical responsibilities of business. It concludes with five ethical business cases, which give the student the opportunity to apply the seeing-knowing-doing model. The student (1) identifies the ethical issues presented in these cases; (2) resolves these issues by using one of the ethical theories described in the chapter, some other ethical theory, or a combination of the theories; and (3) develops strategies for implementing the ethical resolution.

Law Versus Ethics [2-1]

As discussed in Chapter 1, moral concepts strongly affect the law, but law and morality are not the same. Although it is tempting to say "if it's legal, it's moral," such a proposition is generally too simplistic. For example, it would seem gravely immoral to stand by silently while a blind man walks off a cliff if one could prevent the fall by shouting a warning, even though one would not be legally obligated to do so. Similarly, moral questions arise concerning "legal" business practices, such as failing to fulfill a promise that is not legally binding; exporting products banned in the United States to developing countries where they are not prohibited; or slaughtering baby seals for fur coats. The mere fact that these practices are legal does not prevent them from being challenged on moral grounds.

Just as it is possible for legal acts to be immoral, it is equally possible for illegal acts to seem morally preferable to following the law. For example, it is the moral conviction of the great majority of people that those who sheltered Jews in violation of Nazi edicts during World War II and those who committed acts of civil disobedience in the 1950s and 1960s to challenge segregation laws in the United States were acting properly and that the laws themselves were immoral.

Ethical Theories [2-2]

Philosophers have sought for centuries to develop dependable and universal methods for making ethical judgments. In earlier times, some thinkers analogized the discovery of ethical principles with the derivation of mathematical proofs. They asserted that people could discover fundamental ethical rules by applying careful reasoning *a priori*. (*A priori* reasoning is based on theory rather than experimentation and deductively draws conclusions from cause to effect and from generalizations to particular instances.) In more recent times, many philosophers have concluded that although careful reasoning and deep thought assist substantially in moral reasoning, experience reveals that the complexities of the world defeat most attempts to fashion precise, *a priori* guidelines. Nevertheless, a review of the most significant ethical theories can aid the analysis of business ethics issues.

Ethical Fundamentalism [2-2a]

Under **ethical fundamentalism**, or absolutism, individuals look to a central authority or set of rules to guide them in ethical decision making. Some look to the Bible; others look to the Koran, or to the writings of Karl Marx, or to any number of living or deceased prophets. The essential characteristic of this approach is a reliance on a central repository of wisdom. In some cases, such reliance is total. In others, followers of a religion or a spiritual leader may believe that all members of the group are obligated to assess moral dilemmas independently, according to each person's understanding of the dictates of the fundamental principles.

Ethical Relativism [2-2b]

Ethical relativism is a doctrine asserting that actions must be judged by what individuals feel is right or wrong for themselves. It holds that when any two individuals or cultures differ regarding the morality of a particular issue or action, they are both correct because morality is relative. However, although ethical relativism promotes open-mindedness and tolerance, it has limitations. If each person's actions are always correct for that person, then his behavior is, by definition, moral and therefore exempt from criticism. Once a person concludes that criticizing or punishing behavior in some cases is appropriate, he abandons ethical relativism and faces the task of developing a broader ethical methodology.

Although bearing a surface resemblance to ethical relativism, situational ethics actually differs substantially. **Situational ethics** holds that developing precise guidelines for effectively navigating ethical dilemmas is difficult because real-life decision making is so complex. To judge the morality of someone's behavior, the person judging must actually put herself in the other person's shoes to understand what motivated the other to choose a particular course of action. Situational ethics, however, does not cede the ultimate judgment of the propriety of an action to the actor; rather, it insists that, prior to evaluation, a person's decision or act be viewed from the actor's perspective.

Utilitarianism [2-2c]

Utilitarianism is a doctrine that assesses good and evil in terms of the consequences of actions. Those actions that produce the greatest net pleasure compared with net pain are better in a moral sense than those that produce less net pleasure. As Jeremy Bentham, one of the most influential proponents of utilitarianism, proclaimed, a good or moral act is one that results in "the greatest happiness for the greatest number."

The two major forms of utilitarianism are act utilitarianism and rule utilitarianism. **Act utilitarianism** assesses each separate act according to whether it maximizes pleasure over pain. For example, if telling a lie in a particular situation produces more overall pleasure than pain, then an act utilitarian would support lying as the moral thing to do. Rule utilitarians, disturbed by the unpredictability of act utilitarianism and its potential for abuse, follow a different approach. **Rule utilitarianism** holds that general rules must be established and followed even though, in some instances, following rules may produce less overall pleasure than not following them. It applies utilitarian principles in developing rules; thus, it supports rules that on balance produce the greatest satisfaction. Determining whether telling a lie in a given instance would produce greater pleasure than telling the truth is less important to the rule utilitarian than deciding whether a general practice of lying would maximize society's pleasure. If lying would not maximize pleasure generally, then one should follow a rule of not lying even though on occasion telling a lie would produce greater pleasure than would telling the truth.

Utilitarian notions underlie cost-benefit analysis, an analytical tool used by many business and government managers today. **Cost-benefit analysis** first quantifies in monetary terms and then compares the direct and indirect costs and benefits of program alternatives for meeting a specified objective. Cost-benefit analysis seeks the greatest economic efficiency according to the underlying notion that, given two potential acts, the act achieving the greatest output at the least cost promotes the greatest marginal happiness over the less-efficient act, other things being equal.

The chief criticism of utilitarianism is that in some important instances it ignores justice. A number of situations would maximize the pleasure of the majority at great social cost to a minority. Another major criticism of utilitarianism is that measuring pleasure and pain in the fashion its supporters advocate is extremely difficult, if not impossible.

Deontology [2-2d]

Deontological theories (from the Greek word *deon*, meaning duty or obligation) address the practical problems of utilitarianism by holding that certain underlying principles are right or wrong regardless of any pleasure or pain calculations. Believing that actions cannot be measured simply by their results but rather must be judged by means and motives as well, deontologists judge the morality of acts not so much by their consequences but by the motives that lead to them. A person not only must achieve just results but also must employ the proper means.

The eighteenth-century philosopher Immanuel Kant proffered the best-known deontological theory. Under Kant's **categorical imperative**, for an action to be moral it (1) must potentially be a universal law that could be applied consistently and (2) must respect the autonomy and rationality of all human beings and not treat them as an expedient. That is, one should not do anything that he or she would not have everyone do in a similar situation. For example, you should not lie to colleagues unless you support the right of all colleagues to lie to one another. Similarly, you should not cheat others unless you advocate everyone's right to cheat. We apply Kantian reasoning when we challenge someone's behavior by asking: what if everybody acted that way?

Under Kant's approach, it would be improper to assert a principle to which one claimed personal exception, such as insisting that it was acceptable for you to cheat but not for anyone else to do so. This principle could not be universalized because everyone would then insist on similar rules from which only they were exempt.

Kant's philosophy also rejects notions of the end justifying the means. To Kant, every person is an end in himself or herself. Each person deserves respect simply because of his or her humanity. Thus, any sacrifice of a person for the greater good of society would be unacceptable to Kant.

In many respects, Kant's categorical imperative is a variation of the Golden Rule; and, like the Golden Rule, the categorical imperative appeals to the individual's self-centeredness.

As does every theory, Kantian ethics has its critics. Just as deontologists criticize utilitarians for excessive pragmatism and flexible moral guidelines, utilitarians and others criticize deontologists for rigidity and excessive formalism. For example, if one inflexibly adopts as a rule to tell the truth, one ignores situations in which lying might well be justified. A person hiding a terrified wife from her angry, abusive husband would seem to be acting morally by falsely denying that the wife is at the person's house. Yet a deontologist, feeling bound to tell the truth, might ignore the consequences of truthfulness, tell the husband where his wife is, and create the possibility of a terrible tragedy. Another criticism of deontological theories is that the proper course may be difficult to determine when values or assumptions conflict.

Social Ethics Theories [2-2e]

Social ethics theories assert that special obligations arise from the social nature of human beings. Such theories focus not only on each person's obligations to other members of society but also on the individual's rights and obligations within the society. For example, **social egalitarians** believe that society should provide each person with equal amounts of goods and services regardless of the contribution each makes to increase society's wealth.

Two other ethics theories have received widespread attention in recent years. One is the theory of **distributive justice** proposed by Harvard philosopher John Rawls, which seeks to analyze the type of society that people in a "natural state" would establish if they could not determine in advance whether they would be talented, rich, healthy, or ambitious, relative to other members of society. According to distributive justice, the society contemplated through this "veil of ignorance" is the one that should be developed because it considers the needs and rights of all its members. Rawls did not argue that such a society would be strictly egalitarian and that it would unfairly penalize those who turned out to be the most talented and ambitious. Instead, Rawls suggested that such a society would stress equality of opportunity, not of results. On the other hand, Rawls stressed that society would pay heed to the least advantaged to ensure that they did not suffer unduly and that they enjoyed society's benefits. To Rawls, society must be premised on justice. Everyone is entitled to his or her fair share in society, a fairness all must work to guarantee.

In contrast to Rawls, another Harvard philosopher, Robert Nozick, stressed liberty, not justice, as the most important obligation that society owes its members. **Libertarians** stress market outcomes as the basis for distributing society's rewards. Only to the extent that one meets market demands does one deserve society's benefits. Libertarians oppose social interference in the lives of those who do not violate the rules of the marketplace; that is, in the lives of those who do not cheat others and who disclose honestly the nature of their transactions with others. The fact that some end up with fortunes while others accumulate little simply proves that some can play in the market effectively while others cannot. To libertarians, this is not unjust. What is unjust to them is any attempt by society to take wealth earned by citizens and distribute it to those who did not earn it.

These theories and others (e.g., Marxism) judge society in moral terms by its organization and by the way in which it distributes goods and services. They demonstrate the difficulty of ethical decision making in the context of a social organization: behavior that is consistently ethical from individual to individual may not necessarily produce a just society.

Other Theories [2-2f]

The preceding theories do not exhaust the possible approaches to evaluating ethical behavior; several other theories also deserve mention. **Intuitionism** holds that a rational person possesses inherent powers to assess the correctness of actions. Though an individual may refine and strengthen these powers, they are just as basic to humanity as our instincts for survival and self-defense. Just as some people are better artists or musicians, some people have more insight into ethical behavior than others. Consistent with intuitionism is the **good person philosophy**, which declares that if individuals wish to act morally, they should seek out and emulate those who always seem to know the right choice in any given situation and who always seem to do the right thing. One variation of these ethical approaches is the ***Television Test***,

Figure 2-1
Kohlberg's Stages of Moral Development

Levels	Perspective	Justification
Preconventional (Childhood)	Self	Punishment/Reward
Conventional (Adolescent)	Group	Group Norms
Postconventional (Adult)	Universal	Moral Principles

which directs us to imagine that every ethical decision we make is being broadcast on nationwide television. An appropriate decision is one we would be comfortable broadcasting on national television for all to witness.

Ethical Standards in Business [2-3]

In this section, we explore the application of the theories of ethical behavior to the world of business.

Choosing an Ethical System [2-3a]

In their efforts to resolve the moral dilemmas facing humankind, philosophers and other thinkers have struggled for years to refine the various systems previously discussed. All of the systems are limited, however, in terms of applicability and tend to produce unacceptable prescriptions for action in some circumstances. But to say that each system has limits is not to say it is useless. On the contrary, a number of these systems provide insight into ethical decision making and help us formulate issues and resolve moral dilemmas. Furthermore, concluding that moral standards are difficult to articulate and that moral boundaries are imprecise is not the same as concluding that moral standards are unnecessary or nonexistent.

Research by the noted psychologist Lawrence Kohlberg provides some insight into ethical decision making and lends credibility to the notion that moral growth, like physical growth, is part of the human condition. Kohlberg observed that people progress through sequential **stages of moral development** according to two major variables: age and reasoning. During the first level—the ***preconventional level***—a child's conduct is a reaction to the fear of punishment and, later, to the pleasure of reward. Although people who operate at this level may behave in a moral manner, they do so without understanding why their behavior is moral. The rules are imposed upon them. During adolescence—Kohlberg's ***conventional level***—people conform their behavior to meet the expectations of groups, such as family, peers, and eventually society. The motivation for conformity is loyalty, affection, and trust. Most adults operate at this level. According to Kohlberg, some reach the third level—the ***postconventional level***—at which they accept and conform to moral principles because they understand *why* the principles are right and binding. At this level, moral principles are voluntarily internalized, not externally imposed. Moreover, individuals at this stage develop their own universal ethical principles and may even question the laws and values that society and others have adopted. (See Figure 2-1 for Kohlberg's stages of moral development).

Kohlberg believed that not all people reach the third or even the second stage. He therefore argued that essential to the study of ethics was the exploration of ways to help people achieve the advanced stage of postconventional thought. Other psychologists assert that individuals do not pass sequentially from stage to stage but rather function in all three stages simultaneously.

Whatever the source of our ethical approach, we cannot avoid facing moral dilemmas that challenge us to recognize and do the right thing. Moreover, for those who plan business careers, such dilemmas necessarily will have implications for many others—employees, shareholders, suppliers, customers, and society at large.

Corporations as Moral Agents [2-3b]

Because corporations are not persons but rather artificial entities created by the state, whether they can or should be held morally accountable is difficult to determine. Though, clearly, individuals within corporations can be held morally responsible, the corporate entity presents unique problems.

Commentators are divided on the issue. Some insist that only people can engage in behavior that can be judged in moral terms. Opponents of this view concede that corporations are not persons in any literal sense but insist that the attributes of responsibility inherent in corporations are sufficient to justify judging corporate behavior from a moral perspective.

Ethical Responsibilities of Business [2-4]

Many people assert that the only responsibility of business is to maximize profit and that this obligation overrides any ethical or social responsibility. Although our economic system of modified capitalism is based on the pursuit of self-interest, it also contains components to check this motivation of greed. Our system always has recognized the need for some form of regulation, whether by the "invisible hand" of competition, the self-regulation of business, or government regulation.

Regulation of Business [2-4a]

As explained and justified by Adam Smith in *The Wealth of Nations* (1776), the capitalistic system is composed of six "institutions": economic motivation, private productive property, free enterprise, free markets, competition, and limited government. As long as all these constituent institutions continue to exist and operate in balance, the factors of production—land, capital, and labor—combine to produce an efficient allocation of resources for individual consumers and for the economy as a whole. To achieve this outcome, however, Smith's model requires that a number of conditions be satisfied: "standardized products, numerous firms in markets, each firm with a small share and unable by its actions alone to exert significant influence over price, no barriers to entry, and output carried to the point where each seller's marginal cost equals the going market price." E. Singer, *Antitrust Economics and Legal Analysis*.

History has demonstrated that the actual operation of the economy has satisfied almost none of these assumptions. More specifically, the actual competitive process falls considerably short of the assumptions of the classic economic model of perfect competition:

> Competitive industries are never perfectly competitive in this sense. Many of the resources they employ cannot be shifted to other employments without substantial cost and delay. The allocation of those resources, as between industries or as to relative proportions within a single industry, is unlikely to have been made in a way that affords the best possible expenditure of economic effort. Information is incomplete, motivation confused, and decision therefore ill informed and often unwise. Variations in efficiency are not directly reflected in variations of profit. Success is derived in large part from competitive selling efforts, which in the aggregate may be wasteful, and from differentiation of products, which may be undertaken partly by methods designed to impair the opportunity of the buyer to compare quality and price.
>
> C. Edwards, *Maintaining Competition*

In addition to capitalism's failure to allocate resources efficiently, it cannot be relied on to achieve all of the social and public policy objectives a pluralistic democracy requires. For example, the free enterprise model simply does not address equitable distribution of wealth, national defense, conservation of natural resources, full employment, stability in economic cycles, protection against economic dislocations, health and safety, social security, and other important social and economic goals. Increased **regulation of business** has occurred not only to preserve the competitive process in our economic system but also to achieve social goals extrinsic to the efficient allocation of resources, the "invisible hand" and self-regulation by business having failed to bring about these desired results. Such intervention attempts (1) to regulate both "legal" monopolies, such as those conferred by law through copyrights, patents, and trade symbols, and "natural" monopolies, such as utilities, transportation, and communications; (2) to preserve competition by correcting imperfections in the market system; (3) to protect specific groups, especially labor and agriculture, from marketplace failures; and (4) to promote other social goals. Successful government regulation involves a delicate balance between regulations that attempt to preserve competition and those that attempt to advance other social objectives. The latter should not undermine the basic competitive processes that provide an efficient allocation of economic resources.

Corporate Governance [2-4b]

In addition to the broad demands of maintaining a competitive and fair marketplace, another factor demanding the ethical and social responsibility of business is the sheer size and power of individual corporations. The five thousand largest U.S. firms currently produce more than half of the nation's gross national product.

In a classic study published in 1932, Adolf Berle and Gardiner Means concluded that great amounts of economic power had been concentrated in a relatively few large corporations, that the ownership of these corporations had become widely dispersed, and that the shareholders had become far removed from active participation in management. Since their original study, these trends have continued steadily. The five hundred to one thousand large publicly held corporations own the great bulk of the industrial wealth of the United States. Moreover, these corporations are controlled by a small group of corporate officers.

Historically, the boards of many publicly held corporations consisted mainly or entirely of inside directors (corporate officers who also serve on the board of directors). During the past two decades, however, as a result of regu-

lations by the U.S. Securities and Exchange Commission and the stock exchanges, the number and influence of outside directors have increased substantially. Now the boards of the great majority of publicly held corporations consist primarily of outside directors, and these corporations have audit committees consisting entirely of outside directors. Nevertheless, a number of instances of corporate misconduct have been revealed in the first years of this century. In response to these business scandals—involving companies such as Enron, WorldCom, Global Crossing, Adelphia, and Arthur Andersen—in 2002 Congress passed the Sarbanes-Oxley Act. This legislation seeks to prevent these types of scandals by increasing corporate responsibility through the imposition of additional corporate governance requirements on publicly held corporations. (This statute is discussed further in Chapters 6, 35, 39, and 43.)

Moreover, in July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted, representing the most significant change to U.S. financial regulation since the New Deal. Its purposes include improving accountability and transparency in the financial system, protecting consumers from abusive financial services practices, and improving corporate governance in publicly held companies. (The Dodd-Frank Act is discussed further in Chapters 27, 34, 35, 36, 39, 44, and 49.) These developments raise a large number of social, policy, and ethical issues about the governance of large, publicly owned corporations. Many observers insist that companies playing such an important economic role should have a responsibility to undertake projects that benefit society in ways that go beyond mere financial efficiency in producing goods and services. In some instances, the idea of corporate obligations comes from industrialists themselves.

Arguments Against Social Responsibility [2-4c]

A number of arguments oppose business involvement in socially responsible activities: profitability, unfairness, accountability, and expertise.

Profitability As Milton Friedman and others have argued, businesses are artificial entities established to permit people to engage in profit-making, not social, activities. Without profits, they assert, there is little reason for a corporation to exist and no real way to measure the effectiveness of corporate activities. Businesses are not organized to engage in social activities; they are structured to produce goods and services for which they receive money. Their social obligation is to return as much of this money as possible to their direct stakeholders. In a free market with significant competition, the selfish pursuits of corporations will lead to maximizing output, minimizing costs, and establishing fair prices. All other concerns distract companies and interfere with achieving these goals.

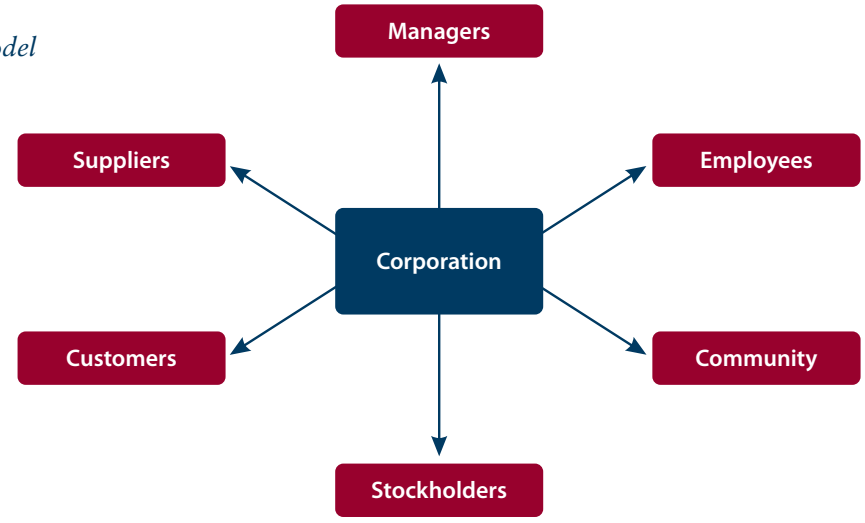
Unfairness Whenever companies stray from their designated role of profit-maker, they take unfair advantage of company employees and shareholders. For example, a company may support the arts or education or spend excess funds on health and safety; however, these funds rightfully belong to the shareholders or employees. The company's decision to disburse these funds to others who may well be less deserving than the shareholders and employees is unfair. Furthermore, consumers can express their desires through the marketplace, and shareholders and employees can decide privately whether they wish to make charitable contributions. In most cases, senior management consults the board of directors about supporting social concerns but does not seek the approval of the company's major stakeholders, thereby effectively disenfranchising these shareholders from actions that reduce their benefits from the corporation.

Accountability Corporations, as previously noted, are private institutions that are subject to a lower standard of **accountability** than are public bodies. Accordingly, a company may decide to support a wide range of social causes and yet submit to little public scrutiny. But a substantial potential for abuse exists in such cases. For one thing, a company could provide funding for a variety of causes its employees or shareholders did not support. It also could provide money "with strings attached," thereby controlling the recipients' agendas for less than socially beneficial purposes. For example, a drug company that contributes to a consumer group might implicitly or explicitly condition its assistance on the group's agreement never to criticize the company or the drug industry.

This lack of accountability warrants particular concern because of the enormous power corporations wield in modern society. Many large companies, like Walmart, Berkshire Hathaway, ExxonMobil, and Apple generate and spend more money in a year than all but a handful of the world's countries. If these companies suddenly began to pursue their own social agendas vigorously, their influence might well rival, and perhaps undermine, that of their national government. In a country like the United States, founded on the principles of limited government and the balance of powers, too much corporate involvement in social affairs might well present substantial problems. Without clear guidelines and accountability, companies pursuing their private visions of socially responsible behavior might well distort the entire process of governance.

There is a clear alternative to corporations engaging in socially responsible action. If society wishes to increase

FIGURE 2-2
The Stakeholder Model



the resources devoted to needy causes, it has the power to do so. Let the corporations seek profits without the burden of a social agenda, let the consumers vote in the marketplace for the products and services they desire, and let the government tax a portion of corporate profits for socially beneficial causes.

Expertise Even though a corporation has an **expertise** in producing and selling its product, it may not possess a talent for recognizing or managing socially useful activities. Corporations become successful in the market because they can identify and meet the needs of their customers. Nothing suggests that this talent spills over into nonbusiness arenas. In fact, critics of corporate participation in social activities worry that corporations will prove unable to distinguish the true needs of society from their own narrow self-interests.

Arguments in Favor of Social Responsibility [2-4d]

First, it should be recognized that even the critics of business acknowledge that the prime responsibility of business is to make a reasonable return on its investment by producing a quality product at a reasonable price. They do not suggest that business entities be charitable institutions. They do assert, however, that business has certain obligations beyond making a profit or not harming society. Such critics contend that business must help to resolve societal problems, and they offer a number of arguments in support of their position.

The Social Contract Society creates corporations and gives them a special social status, including the granting of limited liability, which insulates owners from liability for debts their organizations incur. Supporters of social roles for corporations assert that limited liability and other rights granted to companies carry a responsibility: corporations, just like other members of society, must contribute to its betterment. Therefore, companies owe a moral debt to society to contribute to its overall well-being. Society needs a host of improvements, such as pollution control, safe products, a free marketplace, quality education, cures for illness, and freedom from crime. Corporations can help in each of these areas. Granted, deciding which social needs deserve corporate attention is difficult; however, this challenge does not lessen a company's obligation to choose a cause. Corporate America cannot ignore the multitude of pressing needs that remain, despite the efforts of government and private charities.

A derivative of the social contract theory is the **stakeholder model** for the societal role of the business corporation. Under the stakeholder model, a corporation has fiduciary responsibilities—duty of utmost loyalty and good faith—to all of its stakeholders, not just its stockholders. Historically, the stockholder model for the role of business has been the norm. Under this theory, a corporation is viewed as private property owned by and for the benefit of its owners—the stockholders of the corporation. (For a full discussion of this legal model, see Chapter 35.) The stakeholder model, on the other hand, holds that corporations are responsible to society at large and more directly to all those constituencies on which they depend for their survival. Thus, it is argued that a corporation should be managed for the benefit of all of its stakeholders—stockholders, employees, customers, suppliers, and managers, as well as the local communities in which it operates. (See Figure 2-2 for the stakeholder model of corporate responsibility; compare it with Figure 35-1.)

Less Government Regulation According to another argument in favor of corporate social responsibility, the more responsibly companies act, the less the government must regulate them. This idea, if accurate, would likely appeal to those corporations that typically view regulation with distaste, perceiving it as a crude and expensive way of achieving social goals. To them, regulation often imposes inappropriate, overly broad rules that hamper productivity and require extensive recordkeeping procedures to document compliance. If companies can use more flexible, voluntary methods of meeting a social norm, such as pollution control, then government will be less tempted to legislate norms.

The argument can be taken further. Not only does anticipatory corporate action lessen the likelihood of government regulation, but also social involvement by companies creates a climate of trust and respect that reduces the overall inclination of government to interfere in company business. For example, a government agency is much more likely to show some leniency toward a socially responsible company than toward one that ignores social plights.

Long-Run Profits Perhaps the most persuasive argument in favor of corporate involvement in social causes is that such involvement actually makes good business sense. Consumers often support good corporate images and avoid bad ones. For example, consumers generally prefer to patronize stores with "easy return" policies. Even though the law does not require such policies, companies institute them because they create goodwill—an intangible though indispensable asset for ensuring repeat customers. In the long run, enhanced goodwill often rebounds to stronger profits. Moreover, corporate actions to improve the well-being of their communities make these communities more attractive to citizens and more profitable for business.

Chapter Summary

Definitions

Ethics study of what is right or good for human beings

Business Ethics study of what is right and good in a business setting

Ethical Theories

Ethical Fundamentalism individuals look to a central authority or set of rules to guide them in ethical decision making

Ethical Relativism asserts that actions must be judged by what individuals subjectively feel is right or wrong for themselves

Situational Ethics one must judge a person's actions by first putting oneself in the actor's situation

Utilitarianism moral actions are those that produce the greatest net pleasure compared with net pain
- *Act Utilitarianism* assesses each separate act according to whether it maximizes pleasure over pain
- *Rule Utilitarianism* supports rules that on balance produce the greatest pleasure for society
- *Cost-Benefit Analysis* quantifies the benefits and costs of alternatives

Deontology holds that actions must be judged by their motives and means as well as their results

Social Ethics Theories focus on a person's obligations to other members in society and on the individual's rights and obligations within society
- *Social Egalitarians* believe that society should provide all its members with equal amounts of goods and services regardless of their relative contributions
- *Distributive Justice* stresses equality of opportunity rather than results
- *Libertarians* stress market outcomes as the basis for distributing society's rewards

Other Theories
- *Intuitionism* a rational person possesses inherent power to assess the correctness of actions
- *Good Person* individuals should seek out and emulate good role models

Ethical Standards in Business

Choosing an Ethical System Kohlberg's stages of moral development is a widely accepted model (see Figure 2-1)

Corporations as Moral Agents because a corporation is a statutorily created entity, it is not clear whether it should be held morally responsible

Ethical Responsibilities of Business

Regulation of Business government regulation has been necessary because all the conditions for perfect competition have not been satisfied and free competition cannot by itself achieve other societal objectives

Corporate Governance vast amounts of wealth and power have become concentrated in a small number of corporations, which in turn are controlled by a small group of corporate officers

Arguments Against Social Responsibility

- *Profitability* because corporations are artificial entities established for profit-making activities, their only social obligation should be to return as much money as possible to shareholders
- *Unfairness* whenever corporations engage in social activities, such as supporting the arts or education, they divert funds rightfully belonging to shareholders and/or employees to unrelated third parties
- *Accountability* a corporation is subject to less public accountability than public bodies are
- *Expertise* although a corporation may have a high level of expertise in selling its goods and services, there is absolutely no guarantee that any promotion of social activities will be carried on with the same degree of competence

Arguments in Favor of Social Responsibility

- *The Social Contract* because society allows for the creation of corporations and gives them special rights, including a grant of limited liability, corporations owe a responsibility to society
- *Less Government* Regulation by taking a more proactive role in addressing society's problems, corporations create a climate of trust and respect that has the effect of reducing government regulation
- *Long-Run Profits* corporate involvement in social causes creates goodwill, which simply makes good business sense

QUESTIONS

1. You have an employee who has a chemical imbalance in the brain that causes him to be severely unstable. The medication that is available to deal with this schizophrenic condition is extremely powerful and decreases the taker's life span by one to two years for every year that the user takes it. You know that his doctors and family believe that it is in his best interest to take the medication. What course of action should you follow?

2. You have a very shy employee who is from another country. After a time, you notice that the quality of her performance is deteriorating. You find an appropriate time to speak with her and determine that she is extremely distraught. She tells you that her family has arranged a marriage for her and that she refuses to obey their contract. She further states to you that she is thinking about committing suicide. Two weeks later, after her poor performance continues, you determine that she is on the verge of a nervous breakdown; and once again she informs you that she is going to commit suicide.

   What should you do? Consider further that you can petition a court to have her involuntarily committed to a mental hospital. You know, however, that her family would consider such a commitment an extreme insult and that they might seek retribution. Does this prospect alter your decision? Explain.

3. You receive a telephone call from a company you never do business with requesting a reference on one of your employees, Mary Sunshine. You believe Mary performs in a generally incompetent manner, and you would be delighted to see her take another job. You give her a glowing reference. Is this right? Explain.

4. You have just received a report suggesting that a chemical your company uses in its manufacturing process is very dangerous. You have not read the report, but you are generally aware of its contents. You believe that the chemical can be replaced fairly easily, but that if word gets out, panic