CENGAGE

SMITH & ROBERSON'S

Business Law

18TH EDITION

RICHARD A. MANN
BARRY S. ROBERTS

SMITH & ROBERSON'S

Business Law

EIGHTEENTH EDITION

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Preface

The format of the *Eighteenth Edition* continues the tradition of accuracy, comprehensiveness, and authoritativeness established by prior editions. This text covers the fundamentally important statutory, administrative, and case law that affects business in a succinct and nontechnical but authoritative manner and provides depth sufficient to ensure easy comprehension by students. Chapters contain learning objectives, narrative text, illustrations, cases consisting of selected court decisions, chapter summaries, and end-of-chapter questions and case problems.

Topical Coverage

This text is designed for use in business law and legal environment of business courses generally offered in universities, colleges, schools of business and commerce, community colleges, and junior colleges. By reason of the text's broad and deep coverage, instructors may readily adapt this text to specially designed courses in business law or the legal environment of business by assigning and emphasizing different combinations of chapters.

Emphasis has been placed upon the regulatory environment of business law: the first eight chapters introduce the legal environment of business, and *Part 9* (*Chapters* 39 *through 46*) addresses government regulation of business.

Uniform Certified Public Accountant Examination Preparation

As updated effective July 1, 2021, 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.

In general, the Area II of the REG section blueprint covers 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
  - Uniform Commercial Code
  - Current textbooks covering business law…

More specifically, the 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. 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 www.aicpa.org/becomeacpa/cpaexam.html.

Up-to-Date

The *Eighteenth Edition* has been extensively updated and includes the following:

- The constitutional law chapter (*Chapter 4*) discusses recent U.S. Supreme Court decisions holding that (1) the anticommandeering doctrine invalidated a Federal statute that prohibited States from authorizing sports gambling schemes, (2) Internet retailers can be required to collect sales taxes in States where they have no physical presence, and (3) public employees who choose not to join unions may not be required to help pay for collective bargaining.
- The criminal law chapter (*Chapter 6*) discusses the recent U.S. Supreme Court decisions holding that (1) in both Federal and State courts the Sixth Amendment right to a jury trial requires a unanimous verdict to convict a defendant of a serious offense and (2) 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 limited partnership and LLC chapter (*Chapter 32*) covers the 2001 ReRULPA and low-profit limited liability companies.
- The corporations chapters (*Chapters 33–36*) cover the 2016 Revised Model Business Corporation Act.
- The bankruptcy chapter (*Chapter 38*) discusses the Small Business Reorganization Act of 2019 and the U.S. 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 intellectual property chapter (*Chapter 39*) includes the Copyright Alternative in Small-Claims Enforcement Act of 2019, the Music Modernization Act, and the Marrakesh Treaty of 2013 and discusses the U.S. Supreme Court cases involving the patent exhaustion doctrine, *inter partes* review, and the Lanham Act's (1) disparagement clause and (2) immoral, deceptive, or scandalous clause.
- The consumer protection chapter (*Chapter 41*) covers the Consumer Review Fairness Act of 2016; the Economic Growth, Regulatory Relief Act; the Consumer Protection Act of 2018; and the U.S. Supreme Court case addressing whether the Dodd-Frank Act violates the separation of powers by prohibiting the President from removing the Director of the Consumer Financial Protection Bureau except for "inefficiency, neglect of duty, or malfeasance in office."
- The employment law chapter (*Chapter 42*) discusses the U.S. Supreme Court decisions holding (1) 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 (2) that public employees who choose not to join unions may not be required to help pay for collective bargaining.
- The securities regulation chapter (*Chapter 43*) (1) covers the U.S. Securities and Exchange Commission's amendments to Regulation A, to Rule 147, to Rule 504, and to rules regarding solicitations of interest prior to a registered public offering and smaller reporting companies, and (2) discusses the U.S. 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 environmental law chapter (*Chapter 45*) covers (1) the Chemical Safety for the 21st Century Act, (2) the EPA's Affordable Clean Energy (ACE) Rule, Safer Affordable Fuel-Efficient (SAFE) Vehicles Rule, and Navigable Waters Protection Rule, and (3) the U.S. Supreme Court decision holding that the Clean Water Act requires a permit when there is a direct discharge from a point source into navigable waters or when there is the functional equivalent of a direct discharge.
- The international business law chapter (Chapter 46) covers the United States–Mexico–Canada Agreement (USMCA), the Better Utilization of Investments Leading to Development (BUILD) Act, the U.S. International Development Finance Corporation (DFC), the Export Controls Act of 2018, and the International Antitrust Enforcement Assistance Act of 1994.

- The transfer and control of real property chapter (*Chapter 49*) covers the Economic Growth, Regulatory Relief Act; the Consumer Protection Act of 2018; and the Model Residential Mortgage Satisfaction Act.
- The trusts and decedents' estates chapter (*Chapter 50*) covers the Uniform Trust Code and discusses the U.S. 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.

Readability of Narrative Text

To make the text as readable as possible, all unnecessary "legalese" has been omitted, and 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, which help students relate the material to real-life experiences. The end-of-chapter cases are cross-referenced in the text, as are related topics covered in other chapters.

Chapter Learning Objectives

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

Applying the Law

The Applying the Law feature provides a systematic legal analysis of a realistic situation that focuses on a specific concept presented in the chapter. It consists of (1) the facts of a hypothetical case, (2) an identification of the broad legal issue presented by those facts, (3) a statement of the applicable rule—or applicable legal principles, including definitions, which aid in resolving the legal issue, (4) the application of the rule to the facts, and (5) 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.

Practical Advice

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

Case Treatment

Relevant, carefully selected, and interesting cases illustrate how key principles of business law are applied. All the cases have been edited carefully to preserve the actual language of the court and to show the essential facts of the case, the issue or issues involved, the decision of the court, and the reason for its decision. We have retained the landmark cases from the prior edition. In addition, we have a number of recent cases, including the following U.S. Supreme Court cases: *Murphy v. National Collegiate Athletic Assn.*; *South Dakota v. Wayfair, Inc.*; *Janus v. State, County, and Municipal Employees*; *Carpenter v. United States*; *Cyan, Inc. v. Beaver County Employees Retirement Fund*; *Jam v. International Finance Corp.*; *and Sveen v. Melin*.

Illustrations

We have used more than 210 visually engaging, classroom-tested figures, diagrams, charts, tables, and chapter summaries. The figures and diagrams help students conceptualize the many abstract concepts in the law; the charts and tables not only summarize prior discussions but also help to illustrate relationships among legal rules. Moreover, each chapter has a summary in the form of an annotated outline of the entire chapter, including key terms.

End-of-Chapter Questions and Case Problems

Classroom-proven questions and case problems appear at the end of chapters to test students' understanding of major concepts. Almost all of the chapters include one or more new questions and/or case problems. 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.

Appendices

The appendices include the Constitution of the United States and a comprehensive Dictionary of Legal Terms.

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 which 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

CENGAGE INFUSE

Cengage Infuse for Business Law is the first-of-its-kind digital learning solution that uses your learning management system (LMS) functionality so you can enjoy simple course set-up and intuitive management tools. Offering just the right amount of auto-graded content, you'll be ready to go online at the drop of a hat.

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JUST THE RIGHT AMOUNT OF AUTO-GRADED CONTENT

Let us take care of the basics so you can focus on teaching. Infuse textbook chapter readings, comprehension checks, or end-of-chapter quizzes personalized to this text.

SUPPORT AT EVERY STEP

Access award-winning support 24/7, or take advantage of on-demand resources, including user guides and more.

INSTRUCTOR RESOURCES

Additional instructor resources for this product are available online. Instructor assets include an Instructor's Manual, Educator's Guide, PowerPoint® slides, and a test bank powered by Cognero®. Sign up or sign in at www.cengage.com to search for and access this product and its online resources.

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Richard A. Mann
Barry S. Roberts

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PART 1

The Legal Environment of Business

CH 1 INTRODUCTION TO LAW

CH 2 BUSINESS ETHICS AND THE SOCIAL RESPONSIBILITY OF BUSINESS

CH 3 CIVIL DISPUTE RESOLUTION

CH 4 CONSTITUTIONAL LAW

CH 5 ADMINISTRATIVE LAW

CH 6 CRIMINAL LAW

CH 7 INTENTIONAL TORTS

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CHAPTER 1

Introduction to Law

CHAPTER OUTCOMES

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

- Describe the basic functions of law.
- Distinguish between (1) law and justice and (2) law and morals.
- Distinguish between (1) substantive and procedural law, (2) public and private law, and (3) civil and criminal law.
- Describe the sources of law.
- Explain the principle of *stare decisis*.

Law concerns the relations of individuals with one another 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. The laws of the United States influence the lives of every U.S. citizen. At the same time, the laws of each State influence the lives 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 upon the law.

The law is pervasive. It interacts with and influences the political, economic, and social systems of every civilized society. 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. 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: individuals may choose to perform or not to perform certain acts. Thus, 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, an individual who intends to study the several branches of law known collectively as business law should first consider the nature, classification, and sources of law as a whole. This enables the student not only to understand any given branch of law better but also to understand its relation to other areas of law.

1-1 Nature of Law

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

1-1a DEFINITION OF LAW

A fundamental but difficult question regarding law is this: 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 that a court will decide specific legal questions. William Blackstone, an English jurist, 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." Similarly, Austin, a nineteenth-century English jurist, defined law as a general command that a state or sovereign makes to those who are subject to its authority by laying down a course of action enforced by judicial or administrative tribunals.

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 regime 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 Mr. 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.

1-1b FUNCTIONS OF LAW

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 inevitably arise in a society as complex and interdependent as ours, may involve criminal matters, such as theft, or noncriminal matters, such as an automobile accident. Because disputes threaten the stability of society, 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.

The recognition of private ownership of property is fundamental to our economic system, based as it is upon the exchange of goods and services among privately held units of consumption. Therefore, a second crucial function of law is to protect the owner's use of property and to facilitate 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 leadership and the political structure are brought about by political actions such as elections, legislation, and referenda, rather than by revolution, sedition, and rebellion.

1-1c LEGAL SANCTIONS

A primary function of the legal system is to make sure that legal rules are enforced. **Sanctions** are the means by which the law enforces the decisions of the courts. Without sanctions, laws would be ineffectual and unenforceable.

An example of a sanction in a civil (noncriminal) case is the seizure and sale of the property of a debtor who fails to pay a court-ordered obligation, called a judgment. Moreover, under certain circumstances, a court may enforce its order by finding an offender in contempt and sentencing him to jail until he obeys the court's order. In criminal cases, the principal sanctions are the imposition of a fine, imprisonment, and capital punishment.

1-1d LAW AND MORALS

Although moral and ethical concepts greatly influence the law, morals and law are not the same. They may be considered as two intersecting circles, as shown in *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.

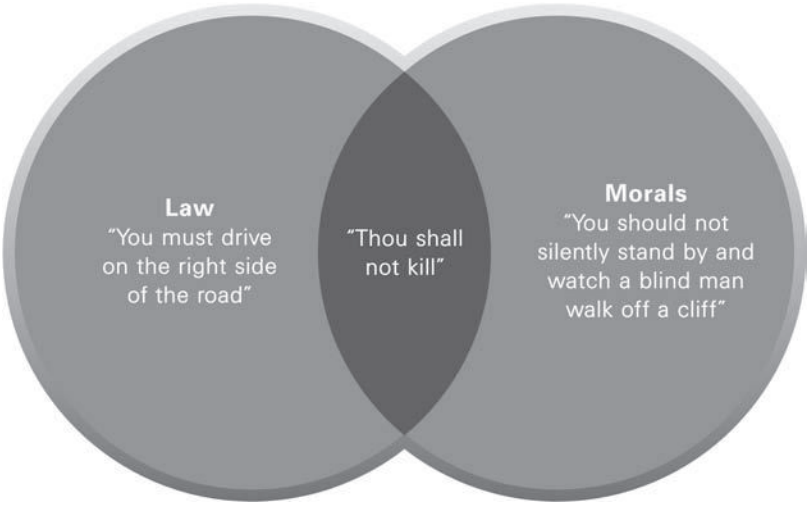
On the other hand, the part of the legal circle that does not intersect the morality circle includes many rules of law that are completely unrelated to morals, such as the rules stating that you must drive on the right side of the road and that you must register before you can vote. Likewise, the portion of the morality circle which does not intersect the legal circle includes moral precepts not enforced by law, such as the moral principle 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.

♦ **SEE FIGURE 1-1:** ***Law and Morals***

1-1e LAW AND JUSTICE

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

FIGURE 1-1 Law and Morals



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 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.

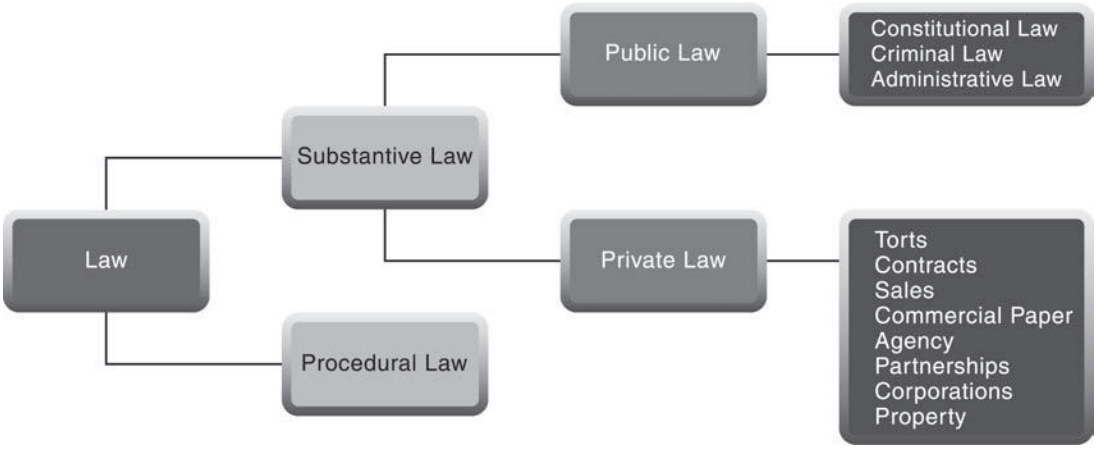
1-2 Classification of Law

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

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 has the capability, 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.

♦ SEE FIGURE 1-2: *Classification of Law*

FIGURE 1-2 Classification of Law



1-2a SUBSTANTIVE AND PROCEDURAL LAW

Substantive law creates, defines, and regulates legal rights and duties. Thus, the rules of contract law that determine when a binding contract is formed are rules of substantive law. This book is principally concerned with substantive law. On the other hand, **procedural law** establishes the rules for enforcing those rights that exist by reason of substantive law. Thus, procedural law defines the method by which one may obtain a remedy in court.

1-2b PUBLIC AND PRIVATE LAW

Public law is the branch of substantive law that deals with the government's rights and powers in its political or sovereign capacity and in its relation 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 relations with one another. Business law is primarily private law.

1-2c CIVIL AND CRIMINAL LAW

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 he has sustained as a result of the defendant's wrongful conduct. The party bringing a civil action (the **plaintiff**) has the burden of proof, which he must sustain by a **preponderance** (greater weight) of the evidence. Whereas the purpose of criminal law is to punish the wrongdoer, the purpose of civil law is to compensate the injured party. The principal forms of relief the civil law provides 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 or omission that public law prohibits in the interest of protecting the public and that the government makes punishable 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. The government prohibits and punishes crimes upon the ground of public policy, which may include the safeguarding of the government itself, human life, or private property. Additional purposes of criminal law include deterrence and rehabilitation.

♦ SEE FIGURE 1-3: *Comparison of Civil and Criminal Law*

1-3 Sources of Law

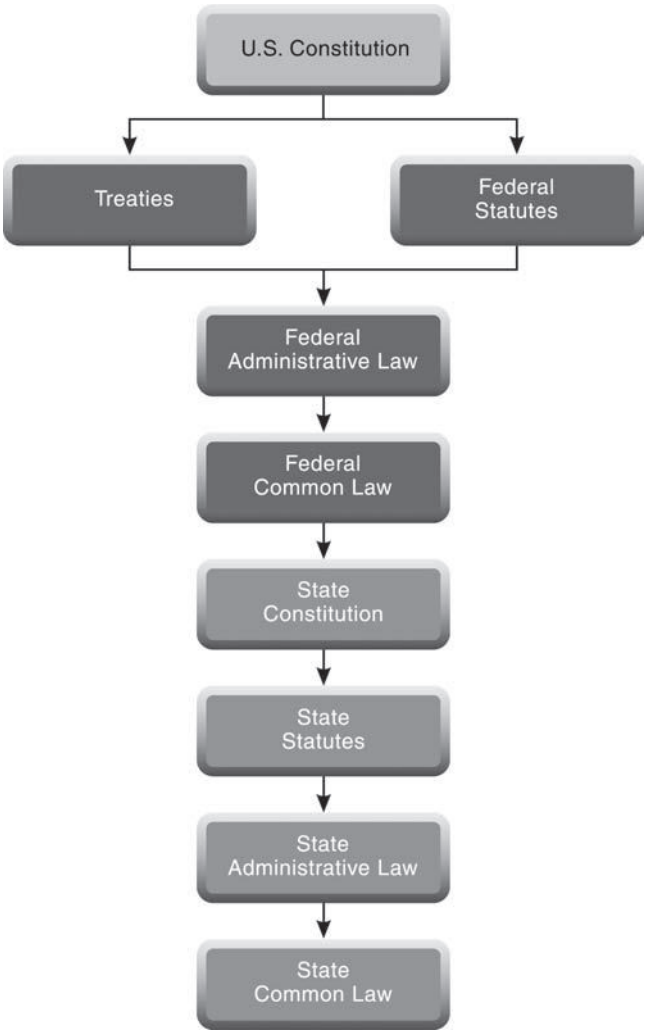
The sources of law in the U.S. legal system are the Federal and State constitutions, Federal treaties, interstate compacts, Federal and State statutes and executive orders, the ordinances of countless local municipal governments, the rules and regulations of Federal and State administrative agencies,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

The *supreme law* of the land is the U.S. Constitution. The Constitution provides that Federal statutes and treaties shall be the supreme law of the land. Federal legislation and treaties are, therefore, 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 of the President and rules and regulations of Federal administrative officials, agencies, and commissions. The Federal courts also contribute considerably to the body of law in the United States.

FIGURE 1-3 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

FIGURE 1-4 Hierarchy of Law



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 that the State's legislature enacts and the case law that its judiciary develops. Likewise, State administrative agencies issue rules and regulations having the force of law, as do executive orders promulgated by the governors of most States. In addition, cities, towns, and villages have limited legislative powers within their respective municipal areas to pass ordinances and resolutions.

♦ **SEE FIGURE 1-4:** ***Hierarchy of Law***

1-3a CONSTITUTIONAL LAW

A **constitution**—the fundamental law of a particular level of government—establishes the governmental structure and allocates power among the levels of government, thereby defining political relationships. One of the fundamental principles on which our government is founded is that of separation of powers. As detailed in the U.S. Constitution, this means that the 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.

1-3b JUDICIAL LAW

The U.S. legal system is a **common law system**, first developed in England. It relies heavily on the judiciary as a source of law and on the adversary system for the adjudication of disputes. In an **adversary system**, the parties, not the court, must initiate and conduct litigation. This approach is based upon 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, India (except Gao), Pakistan, Hong Kong, 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 method of adjudication. 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, known as "case law," "judge-made law," or "common law," that serves as precedent for determining later controversies. In this sense, common law is distinguished from other sources of law such as legislation and administrative rulings.

To evolve steadily and predictably, the common law has developed by application of *stare decisis* (to stand by the decisions). Under the principle of **stare decisis**, courts, in deciding cases, adhere to and rely on rules of law that they or superior courts announced and applied in prior decisions involving similar cases. Judicial decisions thus have two uses: (1) to determine with finality the case currently being decided and (2) to indicate how the courts 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. As Justice Cardozo said, "The inn that shelters for the night is not the journey's end. The law, like the traveler, must be ready for the morrow. It must have a principle of growth."

Equity As the common law developed in England, it became overly rigid and beset with technicalities. Consequently, in many cases, the courts provided no remedies 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 a supplementary system of judicial relief for those who had no adequate remedy at common law. This new system, called **equity**, was administered by a court of chancery presided over by a chancellor. The chancellor, deciding cases on "equity and good conscience," afforded relief in many instances in which common law judges had refused to act or in which the remedy at law was inadequate. Thus, two systems of law administered by different tribunals developed side by side: the common law courts and the courts of equity.

An important difference between law and equity was that the chancellor could issue a **decree**, or order, compelling a defendant to do or refrain from doing a specific act. A defendant who did not comply with the 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.

Equity jurisdiction, in some cases, recognized rights that were enforceable at common law but for which equity 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. Still another remedy not available elsewhere was reformation, in which case, upon the ground of mutual mistake, contracting parties could bring an action to reform or change the language of a written agreement to conform to their actual intentions. Finally, an action for **rescission** of a contract allowed a party to invalidate a contract under certain circumstances.

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. The courts exercised this discretion according to the general legal principles, or **maxims**, that they formulated over the years. A few of these familiar maxims of equity are the following: Equity will not suffer a

wrong to be without a remedy. Equity regards the substance rather than the form. Equity abhors a forfeiture. Equity delights to do justice and not by halves. He who comes into equity must come with clean hands. He who seeks equity must do equity.

In nearly every jurisdiction in the United States, courts of common law and courts of equity have united to form 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.

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 was 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. Wolk, "Restatements of the Law: Origin, Preparation, Availability," 21 *Ohio B.A. Rept.* 663 (1940).

As set out in its charter, the ALI's mission is "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 frequently have been used by courts in support of their opinions. Because they state much of the common law concisely and clearly, relevant portions of the Restatements are frequently relied upon in this book.

1-3c LEGISLATIVE LAW

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 modern emphasis upon 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, courts tend to be hesitant about overruling prior decisions, whereas legislatures frequently repeal prior enactments. In addition, legislatures are independent and able to choose the issues they wish to address, while courts may deal only with issues that arise in actual cases. As a result, legislatures are better equipped to make the dramatic, sweeping, and relatively rapid changes in the law that enable it to respond to numerous and vast technological, social, and economic innovations.

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 have become largely statutory, including partnerships, corporations, sales, commercial paper, secured transactions, insurance, securities regulation, antitrust, and bankruptcy. Because most States enacted 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, 4A, 5, 7, 8, and 9), the District of Columbia, and the Virgin Islands have adopted the UCC. The underlying purposes and policies of the Code are as follows:

1. simplify, clarify, and modernize the law governing commercial transactions;
2. permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and
3. make uniform the law among the various jurisdictions.

Established in 1892, the ULC is composed of more than three hundred 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. Its most widely

adopted uniform 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 text of many of the uniform acts is available on the ULC's website.

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. The ALI has developed a number of model statutory formulations, including the Model Code of Evidence, the Model Penal Code, a Model Land Development Code, and a proposed Federal Securities 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. Article II of 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."

Only the Federal government, not the States, may enter into treaties. 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.

Executive Orders In addition to his executive functions, the President of the United States also has authority to issue laws, which are called executive orders. Typically, Federal legislation specifically delegates this authority. 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.

1-3d ADMINISTRATIVE LAW

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. Administrative functions and activities concern matters of national safety, welfare, and convenience, including the establishment and maintenance of military forces, police, citizenship and naturalization, taxation, coinage of money, elections, environmental protection, and the regulation of transportation, interstate highways, waterways, television, radio, trade and commerce, and, in general, public health, safety, and welfare.

To accommodate the increasing complexity of the social, economic, and industrial life of the nation, the scope of administrative law has expanded enormously. 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." *Federal Trade Commission v. Ruberoid Co.,* 343 U.S. 470 (1952). 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 adjudicate more controversies than all the legislatures and courts combined.

1-4 Legal Analysis

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 trial court opinions 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." Court decisions are found in the official State reports of most States. In addition, West Publishing Company publishes State reports 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.

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 a case is appealed, some, but not all, courts of appeals 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 becomes the appellant, *"Brown v. Jones"* in the appellate court. But because some appellate courts retain the trial court order of names, determining from the title itself who was the plaintiff and who was the defendant is not always possible. The student must read the facts of each case carefully and clearly identify each party in her 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 the student to understand and apply 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 by which students may analyze and brief cases after reading and comprehending the opinion is to write a brief containing the following:

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

By way of example, the edited case of *Ryan v. Friesenhahn* (see *Case 1-1*) is presented after the chapter summary and then briefed using the suggested format.

♦ *See Case 1-1*

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**—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. An example of this type of legal analysis follows.

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 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
Legal Sanctions are means by which the law enforces the decisions of the courts
Law 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 Law
- ***Substantive Law*** law creating rights and duties
- ***Procedural Law*** rules for enforcing substantive law

Public and Private Law
- ***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 Law
- ***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 which, 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 body of law created by administrative agencies to carry out their regulatory powers and duties

C A S E S

CASE 1-1

RYAN v. FRIESENHAHN

Court of Appeals of Texas, 1995
911 S.W.2d 113

Rickhoff, J.

This is an appeal from a take-nothing summary judgment granted the defendants in a social host liability case. Appellants' seventeen-year-old daughter was killed in a single-car accident after leaving appellees' party in an intoxicated condition. While we hold that the appellants were denied an opportunity to amend their pleadings, we also find that their pleadings stated a cause of action for negligence and negligence per se. We reverse and remand.

Todd Friesenhahn, son of Nancy and Frederick Friesenhahn, held an "open invitation" party at his parents' home that encouraged guests to "bring your own bottle." Sabrina Ryan attended the party, became intoxicated, and was involved in a fatal accident after she left the event. According to the Ryans' petition, Nancy and Frederick Friesenhahn were aware of this activity and of Sabrina's condition.

Sandra and Stephen Ryan, acting in their individual and representative capacities, sued the Friesenhahns for wrongful death, negligence, and gross negligence. * * *

* * *

a. The Petition The Ryans pled, in their third amended petition, that Todd Friesenhahn planned a "beer bust" that was advertised by posting general invitations in the community for a party to be held on the "Friesenhahn Property." The invitation was open and general and invited persons to "B.Y.O.B." (bring your own bottle). According to the petition, the Friesenhahns had actual or constructive notice of the party and the conduct of the minors in "possessing, exchanging, and consuming alcoholic beverages."

The Ryans alleged that the Friesenhahns were negligent in (1) allowing the party to be held on the Friesenhahn property; (2) directly or indirectly inviting Sabrina to the party; (3) allowing the party to continue on their property "after they knew that minors were in fact possessing, exchanging, and consuming alcohol"; (4) failing "to provide for the proper conduct at the party"; (5) allowing Sabrina to become intoxicated and failing to "secure proper attention and treatment"; (6) and allowing Sabrina to leave the Friesenhahn property while driving a motor vehicle in an intoxicated state. * * *

b. Negligence Per Se Accepting the petition's allegations as true, the Friesenhahns were aware that minors possessed and consumed alcohol on their property and specifically allowed Sabrina to become intoxicated. The Texas Alcoholic Beverage Code provides that one commits an offense if, with criminal negligence, he "makes available an alcoholic beverage to a minor." [Citation.] The exception for serving alcohol to a minor applies only to the minor's adult parent. [Citation.]

An unexcused violation of a statute constitutes negligence per se if the injured party is a member of the class protected by the statute. [Citation.] The Alcoholic Beverage Code was designed to protect the general public and minors in particular and must be liberally construed. [Citation.] We conclude that Sabrina is a member of the class protected by the Code.

In viewing the Ryans' allegations in the light most favorable to them, we find that they stated a cause of action against the Friesenhahns for the violation of the Alcoholic Beverage Code.

c. Common Law Negligence The elements of negligence include (1) a legal duty owed by one person to another; (2) breach of that duty; and (3) damages proximately caused by the breach. [Citation.] To determine whether a common law duty exists, we must consider several factors, including risk, foreseeability, and likelihood of injury weighed against the social utility of the defendant's conduct, the magnitude of the burden of guarding against the injury and consequences of placing that burden on the defendant. [Citation.] We may also consider whether one party has superior knowledge of the risk, and whether one party has the right to control the actor whose conduct precipitated the harm. [Citation.]

As the Supreme Court in [citation] explained, there are two practical reasons for not imposing a third-party duty on social hosts who provide alcohol to adult guests: first, the host cannot reasonably know the extent of his guests' alcohol consumption level; second, the host cannot reasonably be expected to control his guests' conduct. [Citation.] The Tyler court in [citation] relied on these principles in holding that a minor "had no common law duty to avoid making alcohol available to an intoxicated guest [another minor] who he knew would be driving." [Citation.]

We disagree with the Tyler court because the rationale expressed [by the Supreme Court] in [citation] does not apply to the relationship between minors, or adults and minors. The adult social host need not estimate the extent of a minor's alcohol consumption because serving minors any amount of alcohol is a criminal offense. [Citation.] Furthermore, the social

host may control the minor, with whom there is a special relationship, analogous to that of parent-child. [Citation.]

* * *

As this case demonstrates, serving minors alcohol creates a risk of injury or death. Under the pled facts, a jury could find that the Friesenhahns, as the adult social hosts, allowed open invitations to a beer bust at their house and they could foresee, or reasonably should have foreseen, that the only means of arriving at their property would be by privately operated vehicles; once there, the most likely means of departure would be by the same means. That adults have superior knowledge of the risk of drinking should be apparent from the legislature's decision to allow persons to become adults on their eighteenth birthday for all purposes but the consumption of alcohol. [Citations.]

While one adult has no general duty to control the behavior of another adult, one would hope that adults would exercise special diligence in supervising minors—even during a simple swimming pool party involving potentially dangerous but legal activities. We may have no special duty to watch one adult to be sure he can swim, but it would be ill-advised to turn loose young children without insuring they can swim. When the "party" is for the purpose of engaging in dangerous and illicit activity, the consumption of alcohol by minors, adults certainly have a greater duty of care. [Citation.]

* * * Accordingly, we find that the Ryans' petition stated a common-law cause of action.

* * *

We reverse and remand the trial court's summary judgment.

Brief of Ryan v. Friesenhahn

I. Facts

Todd Friesenhahn, son of Nancy and Frederick Friesenhahn, held an open invitation party at his parents' home that encouraged guests to bring their own bottle. Sabrina Ryan attended the party, became intoxicated, and was involved in a fatal accident after she left the party. Sandra and Stephen Ryan, Sabrina's parents, sued the Friesenhahns for negligence, alleging that the Friesenhahns were aware of underage drinking at the party and of Sabrina's condition when she left the party. The trial court granted summary judgment for the Friesenhahns.

II. Issue

Is a social host who serves alcoholic beverages to a minor liable in negligence for harm suffered by the minor as a result of the minor's intoxication?

III. Decision

In favor of the Ryans. Summary judgment reversed and case remanded to the trial court.

IV. Reasons

Accepting the Ryans' allegations as true, the Friesenhahns were aware that minors possessed and consumed alcohol on their property and specifically allowed Sabrina to become intoxicated. The Texas Alcoholic Beverage Code provides that a person commits an offense if, with criminal negligence, he "makes available an alcoholic beverage to a minor." A violation of a statute constitutes negligence per se if the injured party is a member of the class protected by the statute. Since the Alcoholic Beverage Code was designed to protect the general public and minors in particular, Sabrina is a member of the class protected by the Code. Therefore, we find that the Ryans stated a cause of action against the Friesenhahns for the violation of the Alcoholic Beverage Code.

In considering common-law negligence as a basis for social host liability, the Texas Supreme Court has held that there are two practical reasons for not imposing a third-party duty on social hosts who provide alcohol to adult guests: first, the host cannot reasonably know the extent of his guests' alcohol consumption level; second, the host cannot reasonably be expected to control his guests' conduct. However, this rationale does not apply where the guest is a minor. The adult social host need not estimate the extent of a minor's alcohol consumption because serving minors any amount of alcohol is a criminal offense. Furthermore, the social host may control the minor, with whom there is a special relationship, analogous to that of parent-child.

CHAPTER 2

Business Ethics and the Social Responsibility of Business

CHAPTER OUTCOMES

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

- Describe the differences between law and ethics.
- List and contrast the various ethical theories.
- Explain cost-benefit analysis and its appropriate use.
- Explain Kohlberg's stages of moral development.
- 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 past 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 including 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).

Unethical business practices date from the very beginning of business and continue today. As one court stated in connection with a securities fraud,

> Since the time to which the memory of man runneth not to the contrary, the human animal has been full of cunning and guile. Many of the schemes and artifices have been so sophisticated as almost to defy belief. But the ordinary run of those willing and able to take unfair advantage of others are mere apprentices in the art when compared with the manipulations thought up by those connected in one way or another with transactions in securities.

Ethics can be broadly defined as the study of what is right or good for human beings. It pursues the questions of what people ought to do, what goals they should pursue. In *Business Ethics*, 5th ed., Richard T. DeGeorge provides the following explanation of ethics:

> In its most general sense *ethics is a systematic attempt to make sense of our individual and social moral experience, in such a way as to determine the rules that ought to govern human conduct, the values worth pursuing, and the character traits deserving development in life.* The attempt is systematic and therefore goes beyond what reflective persons tend to do in daily life in making sense of their moral experience, organizing it, and attempting to make it coherent and unified.… Ethics concerns itself with human conduct, taken here to mean human activity that is done knowingly and, to a large extent, willingly. It does not concern itself with automatic responses, or with, for example, actions done in one's sleep or under hypnosis.

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 the law, analyses of ethics have no central authority, such as courts or legislatures, upon which to rely; nor do they have clear-cut, universal standards. Despite these inherent limitations, making meaningful ethical judgments is still possible. To improve ethical decision making, it is important to understand how others have approached the task.

Some examples of the many ethics questions confronting business 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 whistle-blowing. 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 efforts to promote fair competition over the temptation of collusive conduct. The interaction between business and society at large has additional ethical dimensions: pollution of the physical environment, commitment to the community's economic and social infrastructure, and the depletion of natural resources. At the international level, these issues not only recur but also couple themselves to additional ones, 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 strategies for implementation.

This chapter first surveys the most prominent ethical theories, then examines ethical standards in business, and concludes by exploring the ethical responsibilities of business.

2-1 Law Versus Ethics

As discussed in *Chapter 1*, the law is strongly affected by moral concepts, 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 inaccurate and 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 is under no legal obligation 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; manufacturing and selling tobacco or alcohol products; or slaughtering baby seals for fur coats. The mere fact that these practices may be 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. It is, for example, 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 racist segregation laws in the United States were acting properly and that the laws themselves were immoral.

2-2 Ethical Theories

Philosophers have sought for centuries to develop dependable 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, reviewing the most significant ethical theories can aid analysis of business ethics issues.

2-2a ETHICAL FUNDAMENTALISM

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 the writings of Karl Marx, or to any number of living or deceased prophets. The essential characteristic of this approach is a reliance upon a central repository of wisdom. In some cases, such reliance is total. In others, it occurs to a lesser degree: followers of a religion or a spiritual leader may believe that all members of the group have an obligation to assess moral dilemmas independently, according to each person's understanding of the dictates of certain fundamental principles.

2-2b ETHICAL RELATIVISM

Ethical relativism is a doctrine asserting that individuals must judge actions by what they feel is right or wrong for themselves. It holds that both parties to a disagreement regarding a moral question are correct, because morality is relative. While 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 no one can truly criticize it. If a child abuser truly felt it right to molest children, a relativist would accept the proposition that the child abuser was acting properly. As almost no one would accept the proposition that child abuse could ever be ethical, few can truly claim to be relativists. Once a person concludes that criticizing or punishing behavior is, in some cases, 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 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. In this respect, situational ethics shares with ethical relativism the notion that we must judge actions from the perspective of the person who actually made the judgment. From that point on, however, the two approaches differ dramatically. Ethical relativism passes no judgment on what a person did other than to determine that he truly believed the decision was right for him. Much more judgmental, situational ethics insists that once a decision has been viewed from the actor's perspective, a judgment can be made as to whether or not her action was ethical. Situational ethics does not cede the ultimate judgment of propriety to the actor; rather, it insists that another evaluate the actor's decision or act from the perspective of a person in the actor's shoes.

2-2c UTILITARIANISM

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 the 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 by its potential for abuse, follow a different approach by holding that general rules must be established and followed even though, in some instances, following rules may produce less overall pleasure than not following them. In applying utilitarian principles to developing rules, **rule utilitarianism** thus 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 telling a lie occasionally 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, given the underlying notion that acts achieving the greatest output at the least cost promote the greatest marginal happiness over less efficient acts, other things being equal.

The primary purpose of cost-benefit analysis is to choose from alternative courses of action the program that maximizes society's wealth. For example, based on cost-benefit analysis, an auto designer might choose to devote more effort to perfecting a highly expensive air bag that would save hundreds of lives and prevent thousands of disabling injuries than to developing an improved car hood latching mechanism that would produce a less favorable cost-benefit ratio.

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. Under a strict utilitarian approach, for example, it would be ethical to compel a few citizens to undergo painful, even fatal medical tests to develop cures for the rest of the world. For most people, however, such action would be unacceptable. Another major criticism of utilitarianism is that measuring pleasure and pain in the fashion its supporters advocate is extremely difficult, if not impossible.

2-2d DEONTOLOGY

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 calculations regarding pleasure or pain. Deontologists believe that actions cannot be measured simply by their results but must be judged by means and motives as well.

Our criminal laws apply deontological reasoning. Knowing that John shot and killed Marvin is not enough to tell us how to judge John's act. We must know whether John shot Marvin

in anger, in self-defense, or by mistake. Although under any of these motives Marvin is dead, we judge John quite differently depending on the mental process that we believe led him to commit the act. Similarly, deontologists judge the morality of acts not so much by their consequences, but by the motives that lead to them. To act morally, 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. Kant asserted what he called the categorical imperative, which has been summarized as follows:

1. Act only according to that maxim by which you can, at the same time, will that it should become a universal law.
2. Act as never to treat another human being merely as a means to an end.

Thus, for an action to be moral, it (1) must possess the potential to be made a consistently applied universal law and (2) must respect the autonomy and rationality of all human beings and avoid treating them as an expedient. That is, one should avoid doing 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. Because everyone would then insist on similar rules by which to except themselves, this principle could not be universalized.

Kant's philosophy also rejects notions of the end justifying the means. To Kant, every person is an end in himself or herself and 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. Like the Golden Rule, the categorical imperative reflects the idea that people are, to a certain extent, self-centered. As one writer on business ethics notes, this is what makes the Golden Rule so effective:

> It is precisely this self-centeredness of the Golden Rule that makes it so valuable, and so widely acknowledged, as a guide. To inquire of yourself, "How would I feel in the other fellow's place?" is an elegantly simple and reliable method of focusing in on the "right" thing to do. The Golden Rule works not in spite of selfishness, but because of it. Tuleja, *Beyond the Bottom Line*.

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. Less dramatically, one wonders whether the world would effect a higher ethical code by regarding as immoral "white lies" concerning friends' appearance, clothing, or choice of spouse.

2-2e SOCIAL ETHICS THEORIES

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 society. For example, **social egalitarians** believe that society should provide all persons 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 Rawls, the society contemplated through this "veil of ignorance" should be given precedence in terms of development because it considers the needs and rights of all its members. Rawls did not argue, however, that such a society would be strictly egalitarian. That 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 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 the demands of the market does one deserve society's benefits. Libertarians oppose interference by society in their lives as long as they do not violate the rules of the marketplace, that is, as long as they do not cheat others and as long as they honestly disclose 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 then 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 its method of distributing 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.

2-2f OTHER THEORIES

The preceding theories do not exhaust the possible approaches to evaluating ethical behavior but represent the most commonly cited theories advanced over the years. 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 persons** philosophy, which declares that individuals who wish to act morally 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**," which directs us to imagine that every ethical decision we make is being broadcast on nationwide television. Adherents of this approach believe an appropriate decision is one we would be comfortable broadcasting on television for all to witness.

2-3 Ethical Standards in Business

This section explores the application of the theories of ethical behavior to the world of business.

2-3a CHOOSING AN ETHICAL SYSTEM

In their efforts to resolve the moral dilemmas facing humanity, philosophers and other thinkers have struggled for years to refine the various systems discussed previously. No one ethical system is completely precise, however, and each tends occasionally to produce unacceptable prescriptions for action. But to say that a system has limits is not to say it is useless. On the contrary, many such 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 the boundaries are imprecise is not the same as concluding that moral standards are unnecessary or nonexistent.

Research by noted psychologist Lawrence Kohlberg provides 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 stages of moral development according to two major variables: age and education. 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 people 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 even question the laws and values that society and others have adopted.

Kohlberg believed that these stages are sequential and that not all people reach the third or even the second stage. He therefore argued that exploring ways of enabling people to develop to the advanced stage of postconventional thought was essential to the study of ethics. Other psychologists assert that individuals do not pass from stage to stage but rather function in all three stages simultaneously.

♦ **SEE FIGURE 2-1:** ***Kohlberg's Stages of Moral Development***

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

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

2-3b CORPORATIONS AS MORAL AGENTS

Because corporations are not persons but rather artificial entities created by the State, it is not obvious whether they can or should be held morally accountable. As Lord Chancellor Thurlow lamented two hundred years ago, "A company has no body to kick and no soul to damn, and by God, it ought to have both." Clearly, individuals within corporations can be held morally responsible, but the corporate entity presents unique problems.

Commentators are divided on the issue. Some, like philosopher Manuel Velasquez, insist that only people can engage in behavior that can be judged in moral terms. Opponents of this view, like philosophers Kenneth Goodpaster and John Matthews, Jr., concede that corporations are not persons in any literal sense, but insist that the attributes of responsibility inherent in corporations are sufficient in number to permit judging corporate behavior from a moral perspective.

2-4 Ethical Responsibilities of Business

Many people assert that the only responsibility of business is to maximize profit and that this obligation overrides any other ethical or social responsibility. Although our economic system of modified capitalism is based on the pursuit of selfinterest, it 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.

2-4a REGULATION OF BUSINESS

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. Economic motivation assumes that a person who receives an economic return for his effort will work harder; therefore, the economic system should provide greater economic rewards for those who work harder. Private productive property, the means by which economic motivation is exercised, permits individuals to innovate and produce while securing to them the fruits of their efforts. Jack Behrman, a professor of business ethics, has described how the four other institutions combine with these two to bring about industrialized capitalism:

> Free enterprise permits the combination of properties so people can do things together that they can't do alone. Free enterprise means a capitalistic combination of factors of production under decisions of free individuals. Free enterprise is the group expression of the use of private property, and it permits greater efficiency in an industrial setting through variation in the levels and kinds of production.
>
> … The free market operates to equate supply and demand—supply reflecting the ability and willingness to offer certain goods or services and demand reflecting the consumer's ability and willingness to pay. Price is adjusted to include the maximum number of *both* bids and offers. The market, therefore, is *the* decision-making mechanism outside the firm. It is the *means* by which basic decisions are made about the use of resources, and all factors are supposed to respond to it, however they wish.
>
> … Just in case it doesn't work out that way, there is one more institution—the *Government—which* is supposed to set rules and provide protection for the society and its members. That's all, said Smith, that it should do: it should set the rules, enforce them, and stand aside. J. Behrman, *Discourses on Ethics and Business*, pp. 25–29.

As long as all these constituent institutions continue to exist and operate in a balanced manner, 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 the satisfaction of several conditions: "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*, p. 2.

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 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 comprehend or 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. Because the "invisible hand" and self-regulation by business have failed not only to preserve the competitive process in our economic system but also to achieve social goals extrinsic to the efficient allocation of resources, governmental intervention in business has become increasingly common. Such intervention attempts to (1) 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) preserve competition by correcting imperfections in the market system; (3) protect specific groups, especially labor and agriculture, from failures of the marketplace; and (4) 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.

2-5 Corporate Governance

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. Statutorily, their economic power should be delegated by the shareholders to the board of directors, who in turn appoint the officers of the corporation.

> In reality, this legal image is virtually a myth. In nearly every large American business corporation, there exists a management autocracy. One man—variously titled the President, or the Chairman of the Board, or the Chief Executive Officer—or a small coterie of men rule the corporation. Far from being chosen by the directors to run the corporation, this chief executive or executive clique chooses the board of directors and, with the acquiescence of the board, controls the corporation. R. Nader, M. Green, and J. Seligman, *Taming the Giant Corporation*.

In a classic study published in 1932, Adolf Berle and Gardiner Means concluded that significant 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 steadily continued. The large publicly held corporations—numbering five hundred to one thousand—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 regulations by the U.S. Securities and Exchange Commission and the stock exchanges, the number and influence of outside directors has 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, 43,* and *44*.)

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 3, 29, 34, 35, 36, 41, 43,* and *49*.)

These developments raise social, policy, and ethical issues about the governance of large, publicly owned corporations. Many observers insist that companies playing such an important role in economic life 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 obligation comes from industrialists themselves. Andrew Carnegie, for example, advocated philanthropy throughout his life and contributed much of his fortune to educational and social causes.

2-5a ARGUMENTS AGAINST SOCIAL RESPONSIBILITY

Among the arguments opposing business involvement in socially responsible activities are profitability, unfairness, accountability, and expertise.

Profitability As economist 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 to their direct stakeholders as possible. 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 independently 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. Thus, these shareholders are effectively disenfranchised 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 causes its employees or shareholders do 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, Facebook, 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 own governments. 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, the corporate pursuit 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 the resources devoted to needy causes, it has the power to do so. Let 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 customers' needs. Nothing suggests that this talent spills over into nonbusiness arenas. In fact, critics of corporate engagement in social activities worry that corporations will prove unable to distinguish the true needs of society from their own narrow self-interest.

2-5b ARGUMENTS IN FAVOR OF SOCIAL RESPONSIBILITY

First, it should be recognized that even business critics 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. 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 accords them a special social status, including the grant of limited liability, which insulates the owners from liability for debts the organization incurs. 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 still 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 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 a corporation is responsible to society at large, and more directly, to all those constituencies on which it depends for its 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. Compare *Figure 2-2* with *Figure 35-1*.

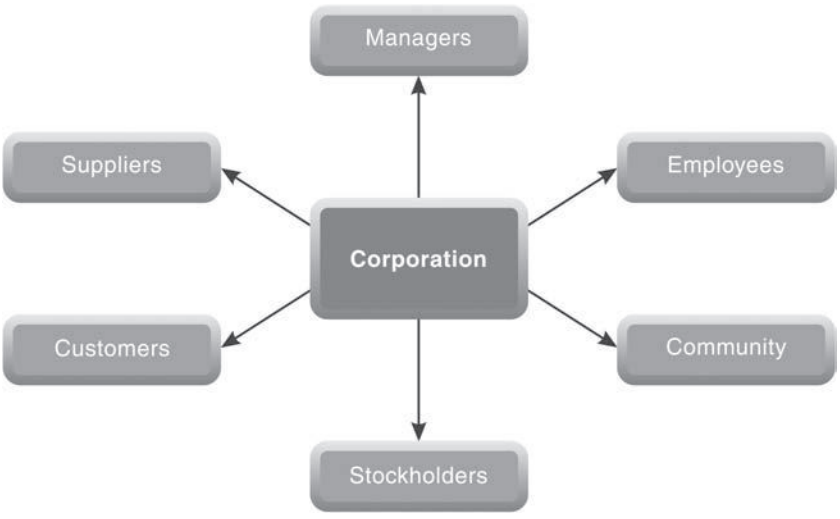
♦ **SEE FIGURE 2-2:** ***The Stakeholder Model***

Less Government Regulation According to another argument in favor of corporate social responsibility, the more responsibly companies act, the less regulation the government must provide. 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 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 leads 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.

FIGURE 2-2 The Stakeholder Model



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 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 actions must be judged by their motives and means as well as their results
Social Ethics Theories focus is 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 governmental 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 profitmaking 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

CASES

Throughout this book, the authors have included court cases dealing with ethical or social issues. Every chapter has at least one case relating to ethical or social issues; in a number of chapters, all of the cases address these issues.

QUESTIONS

1. You have an employee who has a chemical imbalance in the brain that causes him to be severely emotionally unstable. The medication that is available to treat 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 informs you that her family has arranged a marriage for her and that she refuses to obey their contract. She further informs you that she is contemplating suicide. Two weeks later, with her poor performance continuing, you determine that she is on the verge of a nervous breakdown; 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 that Mary is generally incompetent and 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 may set in among employees and community members. A reporter asks if you have seen the report, and you say no. Is your behavior right or wrong? Explain.
5. You and Joe Jones, your neighbor and friend, bought lottery tickets at the corner drugstore. While watching the lottery drawing on television with you that night, Joe leaps from the couch, waves his lottery ticket, and shouts, "I've got the winning number!" Suddenly, he clutches his chest, keels over, and dies on the spot. You are the only living person who knows that Joe, not you, bought the winning ticket. If you substitute his ticket for yours, no one will know of the switch, and you will be $10 million richer. Joe's only living relative is a rich aunt whom he despised. Will you switch his ticket for yours? Explain.
6. Omega, Inc., a publicly held corporation, has assets of $100 million and annual earnings in the range of $13 to $15 million. Omega owns three aluminum plants, which are profitable, and one plastics plant, which is losing $4 million a year. The plastics plant shows no sign of ever becoming profitable because of its very high operating costs, and there is no evidence that the plant and the underlying real estate will increase in value. Omega

decides to sell the plastics plant. The only bidder for the plant is Gold, who intends to use the plant for a new purpose, to introduce automation, and to replace all current employees. Would it be ethical for Omega to turn down Gold's bid and keep the plastics plant operating indefinitely for the purpose of preserving the employees' jobs? Explain.

7. You are the sales manager of a two-year-old electronics firm. At times, the firm has seemed to be on the brink of failure but recently has begun to be profitable. In large part, the profitability is due to the aggressive and talented sales force you recruited. Two months ago, you hired Alice North, an honor graduate from State University who decided that she was tired of the research department and wanted to try sales.

Almost immediately after you send Alice out for training with Brad West, your best salesperson, he begins reporting to you an unexpected turn of events. According to Brad, "Alice is terrific: she's confident, smooth, and persistent. Unfortunately, a lot of our buyers are good old boys who just aren't comfortable around young, bright women. Just last week, Hiram Jones, one of our biggest customers, told me that he simply won't continue to do business with 'young chicks' who think they invented the world. It's not that Alice is a know-it-all. She's not. It's just that these guys like to booze it up a bit, tell some off-color jokes, and then get down to business. Alice doesn't drink, and although she never objects to the jokes, it's clear she thinks they're offensive." Brad believes that several potential deals have fallen through "because the mood just wasn't right with Alice there." Brad adds, "I don't like a lot of these guys' styles myself, but I go along to make the sales. I just don't think Alice is going to make it."

When you call Alice in to discuss the situation, she concedes the accuracy of Brad's report but indicates that she's not to blame and insists that she be kept on the job. You feel committed to equal opportunity but do not want to jeopardize your company's ability to survive. What should you do?

8. Major Company subcontracted the development of part of a large technology system to Start-up Company, a small corporation specializing in custom computer systems. The contract, which was a major breakthrough for Start-up Company and crucial to its future, provided for an initial development fee and subsequent progress payments, as well as a final date for completion.

Start-up Company provided Major Company with periodic reports indicating that everything was on schedule. After several months, however, the status reports stopped coming, and the company missed delivery of the schematics, the second major milestone. As an in-house technical consultant for Major Company, you visit Startup Company and find not only that they are far behind schedule but also that they lied about their previous progress. Moreover, you determine that this slippage has put the schedule for the entire project in jeopardy. The cause of Start-up's slippage was the removal of personnel from your project to work on short-term contracts to obtain money to meet the weekly payroll.

Your company decides that you should stay at Startup Company to monitor its work and to assist in the design of the project. After six weeks and some progress, Start-up is still way behind its delivery dates. Nonetheless, you are now familiar enough with the project to complete it in-house with Major's personnel.

Start-up is still experiencing severe cash flow problems and repeatedly requests payment from Major. But your CEO, furious with Start-up's lies and deceptions, wishes to "bury" Start-up and finish the project using Major Company's internal resources. She knows that withholding payment to Start-up will put them out of business. What do you do? Explain.

9. A customer requests certain sophisticated tests on equipment he purchased from your factory. Such tests are very expensive and must be performed by a third party. The equipment was tested as requested and met all of the industry standards but showed anomalies that could not be explained. Though the problem appears to be minor, you decide to inspect the unit to try to understand the test data—a very expensive and timeconsuming process. You inform the customer of this decision. A problem is found, but it is minor and highly unlikely ever to cause the unit to fail. In addition to the time and expense required to rebuild the equipment, notifying the customer that you are planning to rebuild the unit would also put your overall manufacturing procedures in question.

Should you fix the problem, ship the equipment as is, or inform the customer? Explain.

10. You are a project manager for a company making a major proposal to a Middle Eastern country. Your major competition is from Japan.

a. Your local agent, who is closely tied to a very influential sheikh, would receive a 5 percent commission if the proposal were accepted. Near the date for the decision, the agent asks you for $150,000 to grease the skids so that your proposal is accepted. What do you do?

b. What do you do if, after you say no, the agent goes to your vice president, who provides the money?

c. Your overseas operation learns that most other foreign companies in this Middle Eastern location bolster their business by exchanging currency on the gray market. You discover that your division is twice as profitable as budgeted due to the amount of domestic currency you have received on the gray market. What do you do?

11. Explain what relevance ethics has to business.

12. How should the financial interests of stockholders be balanced with the varied interests of stakeholders? If you were writing a code of conduct for your company, how would you address this issue?

13. A company adopts a policy that (a) prohibits romantic relationships between employees of different ranks and (b) permits romantic relationships between employees of the same rank only if both employees waive in writing their rights to sue the company should the relationship end. Violation of this rule is grounds for dismissal. Is this rule ethical? If not, how should it be revised? Explain.

14. A company prohibits any employee from making disparaging comments about the company through any social media—including online blogs, email, tweets, and other electronic media. Violation of this rule is grounds for dismissal. Explain whether this rule is ethical. If not, how should it be revised? Explain.

BUSINESS ETHICS CASES

The business ethics cases that follow are based on the kinds of situations that companies regularly face in conducting business. You should first read each case carefully and completely before attempting to analyze it. Second, you should identify the most important ethical issues arising from the situation. Often it is helpful to prioritize these issues. Third, you should identify the viable options for addressing these issues and the ethical implications of the identified options. This might include examining the options from the perspectives of the various ethical theories as well as the affected stakeholders. Fourth, you should reach a definite resolution of the ethical issues by choosing what you think is the best option. You should have a well-articulated rationale for your resolution. Finally, you should develop a strategy for implementing your resolution.

PHARMAKON DRUG COMPANY

BACKGROUND

William Wilson, senior vice president of research, development, and medical (RD&M) at Pharmakon Drug Company, received both his Ph.D. in biochemistry and his M.D. from the University of Oklahoma. Upon completion of his residency, Dr. Wilson joined the faculty at Harvard Medical School. He left Harvard after five years to join the research group at Merck & Co. Three years later, he went to GlaxoSmithKline as director of RD&M, and after eight years, Dr. Wilson joined Pharmakon in his current position.

William Wilson has always been highly respected as a scientist, a manager, and an individual. He has also been an outstanding leader in the scientific community, particularly in the effort to attract more minorities into the field.

Pharmakon concentrates its research efforts in the areas of antivirals (with a focus on HIV), the cardiovascular system, the respiratory system, muscle relaxants, the gastrointestinal system, the central nervous system, and consumer health care (i.e., nonprescription and over-the-counter [OTC] medicines). Dr. Wilson is on the board of directors of Pharmakon and the company's executive committee. He reports directly to the chairman of the board and CEO, Mr. Jarred Swenstrum.

DECLINING GROWTH

During the previous eight years, Pharmakon experienced tremendous growth: 253 percent overall, with yearly growth ranging from 12 percent to 25 percent. During this period, Pharmakon's RD&M budget grew from $79 million to $403 million, and the number of employees rose from 1,192 to 3,273 (see *Figure 2-3*). During the previous two years, however, growth in revenue and earnings slowed considerably. Moreover, in the current year, Pharmakon's revenues of $3.55 billion and earnings before taxes of $1.12 billion were up only 2 percent from the previous year. Furthermore, both revenues and earnings are projected to be flat or declining for the next five years.

♦ **SEE FIGURE 2-3:** ***Pharmakon Employment***

The cessation of this period's tremendous growth and the likelihood of future decline have been brought about principally by two causes. First, a number of Pharmakon's most important patents have expired. Competition from generics has begun and could continue to erode its products' market shares. Second, as new types of health-care delivery organizations evolve, pharmaceutical companies' revenues and earnings will in all likelihood be adversely affected.

FIGURE 2-3 Pharmakon Employment

Attribute/Years Ago	1	2	3	4	5	6	7	8
Total Employment	3,273	3,079	2,765	2,372	1,927	1,618	1,306	1,192
Minority Employment	272 (8.35%)	238 (7.7%)	196 (7.15%)	143 (6.0%)	109 (5.7%)	75 (4.6%)	53 (4.1%)	32 (2.7%)
Revenue ($ million)	3,481	3,087	2,702	2,184	1,750	1,479	1,214	986
Profit ($ million)	1,106	1,021	996	869	724	634	520	340
RD&M Budget ($ million)	403	381	357	274	195	126	96	79

PROBLEM AND PROPOSED SOLUTIONS

In response, the board of directors has decided that the company must emphasize two conflicting goals: increase the number of new drugs brought to market and cut back on the workforce in anticipation of rising labor and marketing costs and declining revenues. Accordingly, Dr. Wilson has been instructed to cut costs significantly and to reduce his workforce by 15 percent over the next six months.

Dr. Wilson called a meeting with his management team to discuss the workforce reduction. One of his managers, Leashia Harmon, argued that the layoffs should be made "so that recent gains in minority hiring are not wiped out." The percentage of minority employees had increased from 2.7 percent eight years ago to 8.3 percent in the previous year (see *Figure 2-3*). The minority population in communities in which Pharmakon has major facilities has remained over the years at approximately 23 percent. About 20 percent of the RD&M workforce have a Ph.D. in a physical science or in pharmacology, and another 3 percent have an M.D.

Dr. Harmon, a Ph.D. in pharmacology and head of clinical studies, is the only minority on Dr. Wilson's seven-member management team. Dr. Harmon argued that RD&M has worked long and hard to increase minority employment and has been a leader in promoting Pharmakon's affirmative action plan (see *Figure 2-4*). Therefore, she asserted, all layoffs should reflect this commitment, even if it means disproportionate layoffs of nonminorities.

Dr. Anson Peake, another member of Dr. Wilson's management team and director of new products, argued that

FIGURE 2-4 Pharmakon Affirmative Action Program

Pharmakon Drug Company
Equal Employment Opportunity Affirmative Action Program

POLICY

It is the policy of Pharmakon Drug Co. to provide equal employment opportunities without regard to race, color, religion, sex, national origin, sexual orientation, disability, and veteran status. The Company will also take affirmative action to employ and advance individual applicants from all segments of our society. This policy relates to all phases of employment, including, but not limited to, recruiting, hiring, placement, promotion, demotion, layoff, recall, termination, compensation, and training. In communities where Pharmakon has facilities, it is our policy to be a leader in providing equal employment for all of its citizens.

RESPONSIBILITY FOR IMPLEMENTATION

The head of each division is ultimately responsible for initiating, administering, and controlling activities within all areas of responsibility necessary to ensure full implementation of this policy.

The managers of each location or area are responsible for the implementation of this policy.

All other members of management are responsible for conducting day-to-day activities in a manner to ensure compliance with this policy.

Pharmakon's RD&M division has never discharged a worker except for cause and should adhere as closely as possible to that policy by terminating individuals based solely on relative merit. Dr. Rachel Waugh, director of product development, pointed out that the enormous growth in employment over the past eight years—almost a trebling of the workforce—had made the company's employee performance evaluation system less than reliable. Consequently, she contended that because laying off 15 percent of her group would be extremely difficult and subjective, she preferred to follow a system of seniority.

Dr. Wilson immediately recognized that any system of reducing the workforce would be difficult to implement. Moreover, he was concerned about being fair to employees and maintaining the best qualified group to carry out the area's mission. He was very troubled by a merit or seniority system if it could not maintain the minority gains. In fact, he had even thought about the possibility of using this difficult situation to increase the percentage of minorities to bring it more in line with the minority percentage of the communities in which Pharmakon had major facilities.

MYKON PHARMACEUTICALS, INC.

MYKON'S DILEMMA

Jack Spratt, the newly appointed CEO of Mykon Pharmaceuticals, Inc., sat at his desk and scratched his head for the thousandth time that night. His friends never tired of telling him that unless he stopped this habit, he would remove what little hair he had left. Nevertheless, he had good reason to be perplexed—the decisions he made would determine the future of the company and, literally, the life or death of thousands of people.

As a young, ambitious scientist, Spratt had gained international fame and considerable fortune while rising quickly through the ranks of the scientists at Mykon. After receiving a degree from the Executive MBA program at the Kenan Flagler Business School, University of North Carolina at Chapel Hill, he assumed, in rapid succession, a number of administrative positions at the company, culminating in his appointment as CEO. But no one had told him that finding cures for previously incurable diseases would be fraught with moral dilemmas. Although it was 3:00 A.M., Spratt remained at his desk, unable to stop thinking about his difficult choices. His preoccupation was made worse by the knowledge that pressure from governments and consumers would only increase each day he failed to reach a decision. This pressure had mounted relentlessly since the fateful day he announced that Mykon had discovered the cure for AIDS. But the cure brought with it a curse: there was not enough to go around.

COMPANY BACKGROUND

Mykon, a major international research-based pharmaceutical group, engages in the research, development, manufacture, and marketing of human health-care products for sale in both the prescription and OTC markets. The company's principal prescription medicines include a range of products in the following areas: antiviral, neuromuscular blocking, the cardiovascular system, anti-inflammatory, immunosuppressive, systemic antibacterial, and the central nervous system. Mykon also manufactures other products such as muscle relaxants, antidepressants, anticonvulsants, and respiratory stimulants. In addition, the company markets drugs for the treatment of congestive heart failure and the prevention of organ rejection following transplant.

Mykon's OTC business consists primarily of cough and cold preparations and several topical antibiotics. The company seeks to expand its OTC business in various ways, including the reclassification of some of its prescription drugs to OTC status. Mykon's OTC sales represented 14 percent of the company's sales during last year.

Mykon has a long tradition of excellence in research and development (R&D). The company's expenditures on R&D for the last three financial years constituted 15 percent of its sales.

Mykon focuses its R&D on the following selected therapeutic areas, listed in descending order of expenditure amount: antivirals and other antibiotics, cardiovascular, central nervous system, anticancer, anti-inflammatory, respiratory, and neuromuscular.

Mykon sells its products internationally in more than 120 countries and has a significant presence in two of the largest pharmaceutical markets—the United States and Europe— and a growing presence in Japan. It generated approximately 43 percent and 35 percent of the company's sales from the previous year in the United States and Europe, respectively. The company sells essentially the same range of products throughout the world.

PRODUCTION

Mykon carries out most of its production in Rotterdam in the Netherlands and in Research Triangle Park, North Carolina, in the United States. The latter is the company's world headquarters. The company's manufacturing processes typically consist of three stages: the manufacture of active chemicals, the incorporation of these chemicals into products designed for use by the consumer, and packaging. The firm has an ongoing program of capital expenditure to provide up-to-date production facilities and relies on advanced technology, automation, and computerization of its manufacturing capability to help maintain its competitive position.

Production facilities are also located in ten other countries to meet the needs of local markets and to overcome legal restrictions on the importation of finished products. These facilities engage principally in product formulation and packaging, although plants in certain countries manufacture active chemicals. Last year, Mykon had more than seventeen thousand employees, 27 percent of whom were in the United States. Approximately 21 percent of Mykon's employees were engaged

in R&D, largely in the Netherlands and the United States. Although unions represent a number of the firm's employees, the firm has not experienced any significant labor disputes in recent years, and it considers its employee relations to be good.

RESEARCH AND DEVELOPMENT

In the pharmaceutical industry, R&D is both expensive and prolonged, entailing considerable uncertainty. The process of producing a commercial drug typically takes between eight and twelve years as it proceeds from discovery through development to regulatory approval and finally to the product launch. No assurance exists that new compounds will survive the development process or obtain the requisite regulatory approvals. In addition, research conducted by other pharmaceutical companies may lead at any time to the introduction of competing or improved treatments.

Last year, Mykon incurred approximately 95 percent of its R&D expenditures in the Netherlands and the United States. *Figure 2-5* sets out the firm's annual expenditure on R&D in dollars and as a percentage of sales for each of the last three financial years.

JACK SPRATT

> Every society, every institution, every company, and most important, every individual should follow those precepts that society holds most dear. The pursuit of profits must be consistent with and subordinate to these ideals, the most important of which is the Golden Rule. To work for the betterment of humanity is the reason I became a scientist in the first place. As a child, Banting and Best were my heroes. I could think of no vocation that held greater promise to help mankind. Now that I am CEO I intend to have these beliefs included in our company's mission statement.

These sentiments, expressed by Jack Spratt in a newsmagazine interview, capture the intensity and drive that animate the man. None who knew him was surprised when he set out years ago—fueled by his prodigious energy, guided by his brilliant mind, and financed by Mykon—for the inner reaches of the Amazon Basin to find naturally occurring medicines. Spratt considered it to be his manifest destiny to discover the cure for some dread disease.

His search was not totally blind. Some years earlier, Frans Berger, a well-known but eccentric scientist, had written extensively about the variety of plant life and fungi that flourished in the jungles of the Bobonaza River region deep in the Amazon watershed. Although he spent twenty years there and discovered nothing of medical significance, the vast number and intriguing uniqueness of his specimens convinced Spratt that it was just a matter of time before a major breakthrough would occur.

Spratt also had some scientific evidence. While working in Mykon's laboratory to finance his graduate education in biology and genetics, Spratt and his supervisors had noticed that several fungi not only could restore damaged skin but also, when combined with synthetic polymers, had significant effects on internal cells. Several more years of scientific expeditions and investigations proved promising enough for Mykon to send Spratt and a twenty-person exploration team to the Amazon

FIGURE 2-5 Mykon R&D Expenditures