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Fourteenth Edition

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Roger LeRoy Miller

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Roger LeRoy Miller

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Preface

The study of business law and the legal environment of business has universal applicability. A student entering any field of business must have at least a passing understanding of business law in order to function in the real world. *Business Law: Text and Cases: Commercial Law for Accountants*, Fourteenth Edition, provides the information that students need in an interesting and contemporary way.

This exciting text is tailor-made for those entering the field of accounting and includes topics from *Business Law* that accountants need to know. The text focuses on the basics of business law for accountants—including subjects on the revised 2017 CPA exam. It has a strong emphasis on business organizations, securities law and corporate governance, agency and employment, sales and lease contracts, creditors' rights and bankruptcy, professional liability, government regulation, and property.

For the Fourteenth Edition, I have spent a great deal of effort making this best-selling text more modern, exciting, and visually appealing than ever before. I have added twenty-seven new features, sixty new cases, and eleven new exhibits. The text also contains nearly one hundred and fifty new highlighted and numbered *Cases in Point* and *Examples*, and seventy-three new case problems. Special pedagogical elements within the text focus on legal, ethical, global, and corporate issues while addressing core curriculum requirements.

Highlights of the Fourteenth Edition

Instructors have come to rely on the coverage, accuracy, and applicability of *Business Law: Commercial Law for Accountants*. To make sure that this text engages your students, solidifies their understanding of legal concepts, and provides the best teaching tools available, I now offer the following.

New Coverage of Topics on the Revised 2017 CPA Exam

In 2016, the American Institute of CPAs (AICPA) issued its final report on “Maintaining the Relevance of the

Uniform CPA Exam.” In addition to more focus on critical thinking, authentic applications, and problem solving, the content of the exam will change to an extent.

The Fourteenth Edition of *Business Law: Commercial Law for Accountants* incorporates information on the new topics on the CPA exam, specifically addressing the following:

- Agency law (worker classification and duties of principals and agents)
- Employment law (Affordable Care Act)
- Business organizations (corporate governance issues, including Sarbanes-Oxley compliance and criminal liability for organizations and management)

In addition, the Fourteenth Edition continues to cover topics that are essential to new CPAs who are working with sophisticated business clients, regardless of whether the CPA exam covers these topics. I recognize that today's business leaders must often think “outside the box” when making business decisions. For this reason, I strongly emphasize business and critical thinking elements throughout the text. I have carefully chosen cases, features, and problems that are relevant to business operations. Almost all of the features and cases conclude with some type of critical thinking question. For those teaching future CPAs, this is consistent with the new CPA exam's focus on higher-order skills, such as critical thinking and problem solving.

A Variety of New and Exciting Features

The Fourteenth Edition of *Business Law: Commercial Law for Accountants* is filled with many new features specifically designed to cover current legal topics of high interest. Each feature is related to a topic discussed in the text and ends with *Critical Thinking* or *Business Questions*. **Suggested answers to all the Critical Thinking and Business Questions are included in the Solutions Manual for this text.**

1. **Ethics Today** These features focus on the ethical aspects of a topic discussed in the text to emphasize that ethics is an integral part of a business law course. Examples include:

- Should an Innocent General Partner Be Jointly Liable for Fraud? (Chapter 3)
 - Is It Fair to Classify Uber and Lyft Drivers as Independent Contractors? (Chapter 9)
 - Is It Fair to Dock Employees' Pay for Bathroom Breaks? (Chapter 11)
 - Should There Be More Relief for Student Loan Defaults? (Chapter 21)
2. **Global Insight** These features illustrate how other nations deal with specific legal concepts to give students a sense of the global legal environment. Subjects include:
- Does Cloud Computing Have a Nationality? (Chapter 5)
 - Anti-Bribery Charges Take Their Toll on U.S. and Foreign Corporations (Chapter 6)
 - Islamic Law and *Respondeat Superior* (Chapter 10)
3. **NEW Digital Update** These features are designed to examine cutting-edge cyberlaw topics, such as the following:
- Revenge Porn and Invasion of Privacy (Chapter 8)
 - Should Employees Have a "Right of Disconnecting"? (Chapter 11)
 - Hiring Discrimination Based on Social Media Posts (Chapter 12)
 - Pay with Your Smartphone (Chapter 15)
 - Google Faces an Antitrust Complaint from the European Union (Chapter 26)
4. **Managerial Strategy** These features emphasize the management aspects of business law and the legal environment. Topics include:
- Can a Person Who Is Not a Member of a Protected Class Sue for Discrimination? (Chapter 4)
 - The SEC's New CEO Pay-Ratio Disclosure Rule (Chapter 7)
 - Union Organizing Using Your Company's E-Mail System (Chapter 11)

Highlighted and Numbered *Examples* and *Case in Point* Illustrations

Many instructors use cases and examples to illustrate how the law applies to business. Students understand legal concepts better in the context of their real-world application. Therefore, for this edition of *Business Law: Commercial Law for Accountants*, I have expanded the number of highlighted numbered *Examples* and *Cases in Point* in every chapter. I have added 103 new *Cases in Point* and 43 new *Examples*.

Examples illustrate how the law applies in a specific situation. *Cases in Point* present the facts and issues of

an actual case and then describe the court's decision and rationale. These two features are uniquely designed and consecutively numbered throughout each chapter for easy reference. The *Examples* and *Cases in Point* are integrated throughout the text to help students better understand how courts apply legal principles in the real world.

New Unit-Ending *Application and Ethics* Features

For the Fourteenth Edition, I have created an entirely new feature that concludes each of the five units in the text. Each of these *Application and Ethics* features provides additional analysis on a topic related to that unit and explores its ethics ramifications. Each of the features ends with two questions—a *Critical Thinking* and an *Ethics Question*. Some topics covered by these features include the following:

- Business Start-Ups Online (Unit 1)
- Health Insurance and Small Business (Unit 2)
- Federal Student Loans—Default and Discharge (Unit 3)
- Business Planning for Divorce (Unit 5)

Suggested answers to the questions in *Application and Ethics* features are included in the *Solutions Manual* for this text.

New Cases and Case Problems

For the Fourteenth Edition of *Business Law: Commercial Law for Accountants*, I have added sixty new cases and seventy-three new case problems, most from 2016 and 2015. The new cases and case problems have been carefully selected to illustrate important points of law and to be of high interest to students and instructors. I have made it a point to find recent cases that enhance learning and are relatively easy to understand.

1. **Spotlight Cases and Classic Cases.** Certain cases and case problems that are exceptionally good teaching cases are labeled as *Spotlight Cases* and *Spotlight Case Problems*. Examples include *Spotlight on Baseball Cards*, *Spotlight on Holiday Inns*, and *Spotlight on the Seattle Mariners*. Instructors will find these *Spotlight Cases* useful to illustrate the legal concepts under discussion, and students will enjoy studying the cases because they involve interesting and memorable facts. Other cases have been chosen as *Classic Cases* because they establish a legal precedent in a particular area of law.

2. **Critical Thinking Section.** Each case concludes with a *Critical Thinking* section, which normally includes two questions. The questions may address *Legal Environment*, *E-Commerce*, *Economic*, *Environmental*, *Ethical*, *Global*, *Political*, or *Technological* issues, or they may ask *What If the Facts Were Different?* Each *Classic Case* has a section titled *Impact of This Case on Today's Law* and one *Critical Thinking* question.
3. **Longer Excerpts for Case Analysis.** I have also included one longer case excerpt in every chapter—labeled *Case Analysis*—followed by three *Legal Reasoning Questions*. The questions are designed to guide students' analysis of the case and build their legal reasoning skills. These *Case Analysis* cases may be used for case-briefing assignments and are also tied to the *Special Case Analysis* questions found in every unit of the text.

Suggested answers to all case-ending questions and case problems are included in the *Solutions Manual* for this text.

Business Case Problem with Sample Answer in Each Chapter

In response to those instructors who would like students to have sample answers available for some of the questions and case problems, I include a *Business Case Problem with Sample Answer* in each chapter. The *Business Case Problem with Sample Answer* is based on an actual case, and students can find a sample answer at the end of the text. **Suggested answers to the *Business Case Problems with Sample Answers* are provided in Appendix C at the end of the text and in the *Solutions Manual* for this text.**

New Exhibits and Concept Summaries

For this edition, we have spent considerable effort reworking and redesigning all of the exhibits and *Concept Summaries* in the text to achieve better clarity and more visual appeal. In addition, we have added eleven new exhibits.

Special Case Analysis Questions

For one chapter in every unit of the text, I provide a *Special Case Analysis* question that is based on the *Case Analysis* excerpt in that chapter. These special questions appear in the *Business Case Problems* section at the ends of selected chapters.

The *Special Case Analysis* questions are designed to build students' analytical skills. They test students' ability to perform IRAC (Issue, Rule, Application, and Conclusion) case analysis. Students must identify the legal issue presented in the chapter's *Case Analysis*, understand the rule of law, determine how the rule applies to the facts of the case, and describe the court's conclusion. Instructors can assign these questions as homework or use them in class to elicit student participation and teach case analysis. **Suggested answers to the *Special Case Analysis* questions can be found in the *Solutions Manual* for this text.**

Reviewing Features in Every Chapter

In the Fourteenth Edition of *Business Law: Commercial Law for Accountants*, I continue to offer a *Reviewing* feature at the end of every chapter to help solidify students' understanding of the chapter materials. Each *Reviewing* feature presents a hypothetical scenario and then asks a series of questions that require students to identify the issues and apply the legal concepts discussed in the chapter.

These features are designed to help students review the chapter topics in a simple and interesting way and see how the legal principles discussed in the chapter affect the world in which they live. An instructor can use these features as the basis for in-class discussion or encourage students to use them for self-study prior to completing homework assignments. **Suggested answers to the questions posed in the *Reviewing* features can be found in the *Solutions Manual* for this text.**

Two Issue Spotters

At the conclusion of each chapter, I have included a special section with two *Issue Spotters* related to the chapter's topics. These questions facilitate student learning and review of the chapter materials. **Suggested answers to the *Issue Spotters* in every chapter are provided in Appendix B at the end of the text and in the *Solutions Manual* for this text.**

Legal Reasoning Group Activities

For instructors who want their students to engage in group projects, each chapter of the Fourteenth Edition includes a special *Legal Reasoning Group Activity*. Each activity begins by describing a business scenario and then poses several specific questions pertaining to the scenario. Each question is to be answered by a different group of

students based on the information in the chapter. These projects may be used in class to spur discussion or as homework assignments. **Suggested answers to the *Legal Reasoning Group Activities* are included in the *Solutions Manual* for this text.**

Supplements/Digital Learning Systems

Business Law: Commercial Law for Accountants, Fourteenth Edition, provides a comprehensive supplements package designed to make the tasks of teaching and learning more enjoyable and efficient. The following supplements and exciting new digital products are offered in conjunction with the text.

MindTap

MindTap for *Business Law: Commercial Law for Accountants*, Fourteenth Edition, is a fully online, highly personalized learning experience built upon Cengage Learning content. MindTap combines student learning tools—such as readings, multimedia, activities, and assessments from CengageNOW—into a singular Learning Path that intuitively guides students through their course.

Instructors can personalize the experience by customizing authoritative Cengage Learning content and learning tools. MindTap offers instructors the ability to add their own content in the Learning Path with apps that integrate into the MindTap framework seamlessly with Learning Management Systems (LMS).

MindTap includes:

- **An Interactive Book with Whiteboard Videos and Interactive Cases.**
- **Automatically graded homework** with the following consistent question types:
 - **Worksheets**—Interactive Worksheets prepare students for class by ensuring reading and comprehension.
 - **Video Activities**—Real-world video exercises make business law engaging and relevant.
 - **Brief Hypotheticals**—These applications provide students practice in spotting the issue and applying the law in the context of a short, factual scenario.
 - **Case Problem Analyses**—These promote deeper critical thinking and legal reasoning by guiding students step-by-step through a case

problem and then adding in a critical thinking section based on “What If the Facts Were Different?” These now include a third section, a writing component, which requires students to demonstrate their ability to forecast the legal implications of real-world business scenarios.

- **Personalized Student Plan with multimedia study tools and videos.**
- **New Adaptive Test Prep** helps students study for exams.
- **Test Bank.**
- **Reporting and Assessment options.**

By using the MindTap system, students can complete the assignments online and can receive instant feedback on their answers. Instructors can utilize MindTap to upload their course syllabi, create and customize homework assignments, and keep track of their students’ progress. By hiding, rearranging, or adding content, instructors control what students see and when they see it to match the Learning Path to their course syllabus exactly. Instructors can also communicate with their students about assignments and due dates, and create reports summarizing the data for an individual student or for the whole class.

Cengage Learning Testing Powered by Cognero

Cengage Learning Testing Powered by Cognero is a flexible, online system that allows you to do the following:

- Author, edit, and manage *Test Bank* content from multiple Cengage Learning solutions.
- Create multiple test versions in an instant.
- Deliver tests from your LMS, your classroom, or wherever you want.

Start Right Away! *Cengage Learning Testing Powered by Cognero* works on any operating system or browser.

- No special installs or downloads are needed.
- Create tests from school, home, the coffee shop—anywhere with Internet access.

What Will You Find?

- *Simplicity at every step.* A desktop-inspired interface features drop-down menus and familiar intuitive tools that take you through content creation and management with ease.
- *Full-featured test generator.* Create ideal assessments with your choice of fifteen question

types—including true/false, multiple choice, opinion scale/Likert, and essay). Multi-language support, an equation editor, and unlimited meta-data help ensure your tests are complete and compliant.

- *Cross-compatible capability.* Import and export content to and from other systems.

Instructor's Companion Web Site

The Web site for the Fourteenth Edition of *Business Law: Commercial Law for Accountants* can be found by going to www.cengagebrain.com and entering ISBN 9781305967281. The Instructor's Companion Web Site contains the following supplements:

- ***Instructor's Manual.*** Includes sections entitled “Additional Cases Addressing This Issue” at the end of selected case synopses.
- ***Solutions Manual.*** Provides answers to all questions presented in the text, including the questions in each case and feature, the *Issue Spotters*, the *Business Scenarios* and *Business Case Problems*, and the unit-ending features.
- ***Test Bank.*** A comprehensive test bank that contains multiple-choice, true/false, and short essay questions.
- ***Case-Problem Cases.***
- ***Case Printouts.***
- ***PowerPoint Slides.***
- ***Lecture Outlines.***

For Users of the Thirteenth Edition

First of all, I want to thank you for helping make *Business Law* the best-selling business law text in America today. Second, I want to make you aware of the numerous additions and changes that have been made in this edition—many in response to comments from reviewers.

Every chapter of the Fourteenth Edition has been revised as necessary to incorporate new developments in the law or to streamline the presentations. Other major changes and additions for this edition include the following:

- Chapter 1 (Business Ethics)—This chapter contains two new cases, two new *Issue Spotters*, three new *Cases in Point* (including a case involving Tom Brady's suspension from the NFL as a result of “deflategate”), and three new case problems. The chapter includes a section on business ethics

and social media, and discusses stakeholders and corporate social responsibility. The chapter also provides step-by-step guidance on making ethical business decisions and includes materials on global business ethics. A new *Digital Update* feature examines whether employees should have the right to disconnect from their electronic devices after work hours.

- Chapters 2 through 7 (the remaining chapters of the Law and Business Management Unit)—This unit has been thoroughly revised and updated to improve flow and clarity and to provide more practical information and recent examples. I have included fifteen new cases and twenty new *Cases in Point* throughout the unit. After discussing ethics in the first chapter, I start off discussing small business forms, then move to partnerships, limited liability companies, and finally corporations. All of the chapters in the unit include new features. For instance, in Chapter 5, there is a *Global Insight* feature on whether cloud computing has a nationality and a *Digital Update* feature on software programs that can predict employee misconduct. I discuss crowdfunding and venture capital in that chapter as well. I have added new exhibits and key terms. In the chapter on securities law (Chapter 7), I have updated the materials on Regulation A offerings because the cap went from 5 million to 50 million in 2015. I also discuss how to deal with the SEC's new CEO pay-ratio disclosure rule in a *Managerial Strategy* feature.
- Chapter 9 (Agency Formation and Duties) and Chapter 10 (Agency Liability and Termination)—These two chapters have been updated to reflect the realities of the gig economy in which many people are working as independent contractors. A new *Ethics Today* feature continues that emphasis with a discussion of whether Uber and Lyft drivers should be considered employees rather than independent contractors. There is also a new *Global Insight* feature in Chapter 10 concerning Islamic law and *respondeat superior*. In addition, five new *Examples*, five new *Cases in Point*, and five new case problems have been added in these two chapters to help students comprehend the important issues and liability in agency relationships.
- Chapter 11 (Employment, Immigration, and Labor Law) and Chapter 12 (Employment Discrimination)—These two chapters covering employment law have been thoroughly updated to

include discussions of legal issues facing employers today. Chapter 11 has three new cases, three new *Cases in Point*, three new *Examples* (including one involving wage claims of the Oakland Raiders cheerleaders), and three new case problems. I have added two new features—an *Ethics Today* on whether employees should receive paid bathroom breaks and a *Managerial Strategy* on union organizing using company e-mail systems. Chapter 12 has a new section discussing discrimination based on military status and new coverage of same-sex discrimination and discrimination against transgender persons. All three cases are new. There are seven new *Cases in Point*, five new *Examples*, a new exhibit, and three new case problems. A *Digital Update* feature discusses hiring discrimination based on social media posts. I discuss relevant United States Supreme Court decisions affecting employment issues throughout both chapters.

- Chapter 13 (The Formation of Sales and Lease Contracts) and Chapter 14 (Performance and Breach of Sales and Lease Contracts)—The coverage of the Uniform Commercial Code has been streamlined and simplified. I have added four new cases and ten new *Cases in Point* to increase student comprehension, as well as new business scenarios and case problems.
- Chapters 15 through 17 (the negotiable instruments chapters)—The three negotiable instruments chapters have been revamped and simplified. I have added numerous new *Cases in Point* and *Examples* to clarify difficult topics for students. A *Digital Update* feature discusses paying with smartphones.
- Chapter 18 (Banking in the Digital Age)—I have updated this entire chapter to reflect the realities of banking in today's digital world. All three cases are new and recent. There are three new *Cases in Point*, a new *Issue Spotter*, and three new case problems. A new *Digital Update* feature explains how electronic payment systems are reducing the use of checks.
- Chapter 19 (Creditors' Rights and Remedies), Chapter 20 (Secured Transactions), and Chapter 21 (Bankruptcy Law)—These three chapters have been revised to be more up to date and comprehensible. Each chapter has two new cases and a new feature. We have also streamlined the materials to focus on those concepts that students need to know. I have added new exhibits, *Concept*

Summaries, key terms, *Examples*, and *Cases in Point* to better clarify concepts. Chapter 20 (Secured Transactions) was substantially reworked to clarify the general principles and exceptions. Chapter 21 (Bankruptcy Law) includes updated dollar amounts of various provisions of the Bankruptcy Code, six new *Cases in Point*, and an *Ethics Today* feature on whether there should be more relief for student loan debt.

- Chapter 22 (Professional Liability and Accountability)—The discussion of global accounting rules has been updated and I have included new subheads to discuss actual and constructive fraud. I have created a new exhibit to clarify the three basic rules of an accountant's liability to third parties, as well as three new *Cases in Point* and one new *Example*. There is also a new *Ethics Today* feature discussing a professional's responsibilities with respect to protecting data stored in the cloud.
- Chapter 24 (Consumer Law) and Chapter 26 (Antitrust Law)—These two chapters include all new cases, and both have been significantly updated with new coverage, *Examples*, and *Cases in Point*. A *Digital Update* in Chapter 24 deals with "native" ads on the Internet, and a *Digital Update* in Chapter 26 discusses the European Union's antitrust complaint against Google.
- Chapter 27 (Personal Property and Bailments) and Chapter 28 (Real Property and Landlord-Tenant Law)—I have rearranged the materials in the property chapters somewhat and now cover fixtures in the real property chapter. Each chapter includes two new cases as well as a *Classic Case* or *Spotlight Case*. There are six new *Examples*, seven new *Cases in Point*, two new exhibits, and seven new case problems in these two chapters. Both chapters also include new features (an *Ethics Today* and a *Digital Update*).
- Chapter 29 (Intellectual Property)—The materials on intellectual property rights have been thoroughly revised and updated to reflect the most current laws and trends. The 2016 case involves the Hustler Club and a trademark infringement claim between brothers. A *Digital Update* feature examines the problem of patent trolls. There are eleven new *Cases in Point*, including cases involving FedEx's color and logo, Google's digitalization of books, and how the Sherlock Holmes copyright fell into the public domain.

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R.L.M.

*To Dan Benjamin,
I continue to marvel
at your ability to
improve my work.
Thanks.
R.L.M.*

Unit One

Law and Business Management



- 1. Business Ethics**
- 2. Small Businesses and Franchises**
- 3. All Forms of Partnerships**
- 4. Limited Liability Companies and Special Business Forms**
- 5. Corporate Formation and Financing**
- 6. Corporate Directors, Officers, and Shareholders**
- 7. Securities Law and Corporate Governance**



CHAPTER 1

Business Ethics

One of the most complex issues businesspersons and corporations face is ethics. It is not as well defined as the law, and yet it can have substantial impacts on a firm's finances and reputation, especially when the firm is involved in a well-publicized scandal. Some scandals arise from activities that are legal, but are ethically questionable. Other

scandals arise from conduct that is both illegal and unethical.

Consider, for example, Volkswagen's corporate executives, who were accused of cheating on the pollution emissions tests of millions of vehicles that were sold in the United States. Volkswagen admitted in 2015 that it had installed "defeat device" software in its diesel models. The

software detected when the car was being tested and changed its performance to improve the test outcome. As a result, the diesel cars showed low emissions—a feature that made the cars more attractive to today's consumers. Ultimately, millions of Volkswagen vehicles were recalled, and the company suffered its first quarterly loss in fifteen years.

1-1 Business Ethics

At the most basic level, the study of **ethics** is the study of what constitutes right or wrong behavior. It is a branch of philosophy focusing on morality and the way moral principles are derived and implemented. Ethics has to do with the fairness, justness, rightness, or wrongness of an action.

The study of **business ethics** typically looks at the decisions businesses make or have to make and whether those decisions are right or wrong. It has to do with how businesspersons apply moral and ethical principles in making their decisions. Those who study business ethics also evaluate what duties and responsibilities exist or should exist for businesses.

In this book, we include an *Application and Ethics* feature at the end of each unit to expand on the concepts of business ethics discussed in that unit. We also cover ethical issues in *Ethics Today* features that appear in a number of chapters.

1-1a Why Is Studying Business Ethics Important?

Over the last hundred years, the public perception of the corporation has changed from an entity that primarily generates revenues for its owners to an entity that participates in society as a corporate citizen. Originally, the only

goal or duty of a corporation was to maximize profits. Although many people today may view this idea as greedy or inhumane, the rationale for the profit-maximization theory is still valid.

Profit Maximization In theory, if all firms strictly adhere to the goal of profit maximization, resources flow to where they are most highly valued by society. Corporations can focus on their strengths, and other entities that are better suited to deal with social problems and perform charitable acts can specialize in those activities. The government, through taxes and other financial allocations, can shift resources to those other entities to perform public services. Thus, in an ideal world, profit maximization leads to the most efficient allocation of scarce resources.

The Rise of Corporate Citizenship Over the years, as resources purportedly were not sufficiently reallocated to cover the costs of social needs, many people became dissatisfied with the profit-maximization theory. Investors and others began to look beyond profits and dividends and to consider the **triple bottom line**—a corporation's profits, its impact on people, and its impact on the planet. Magazines and Web sites began to rank companies based on their environmental impacts and their ethical decisions. The corporation came to be viewed as a "citizen" that was expected to participate in bettering communities and society.

Even so, many still believe that corporations are fundamentally profit-making entities that should have no responsibility other than profit maximization.

1-1b The Importance of Ethics in Making Business Decisions

Whether one believes in profit maximization or corporate citizenship, ethics is important in making business decisions. When making decisions, a business should evaluate:

1. The legal implications of each decision.
2. The public relations impact.
3. The safety risks for consumers and employees.
4. The financial implications.

This four-part analysis will assist the firm in making decisions that not only maximize profits but also reflect good corporate citizenship.

Long-Run Profit Maximization In attempting to maximize profits, corporate executives and employees have to distinguish between *short-run* and *long-run* profit maximization. In the short run, a company may increase its profits by continuing to sell a product even though it knows that the product is defective. In the long run, though, because of lawsuits, large settlements, and bad publicity, such unethical conduct will cause profits to suffer. Thus, business ethics is consistent only with long-run profit maximization. An overemphasis on short-term profit maximization is the most common reason that ethical problems occur in business.

■ **CASE IN POINT 1.1** When the powerful narcotic painkiller OxyContin was first marketed, its manufacturer, Purdue Pharma, claimed that it was unlikely to lead to drug addiction or abuse. Internal company documents later showed that the company's executives knew that OxyContin could be addictive, but kept this risk a secret to boost sales and maximize short-term profits.

Subsequently, Purdue Pharma and three former executives pleaded guilty to criminal charges that they had misled regulators, patients, and physicians about OxyContin's risks of addiction. Purdue Pharma agreed to pay \$600 million in fines and other payments. The three former executives agreed to pay \$34.5 million in fines and were barred from federal health programs for a period of fifteen years. Thus, the company's focus on maximizing profits in the short run led to unethical conduct that hurt profits in the long run.¹ ■

1. *United States v. Purdue Frederick Co.*, 495 F.Supp.2d 569 (W.D.Va. 2007).

The Internet Can Ruin Reputations In the past, negative information or opinions about a company might remain hidden. Now, however, cyberspace provides a forum where disgruntled employees, unhappy consumers, or special interest groups can post derogatory remarks. Thus, the Internet has increased the potential for a major corporation (or other business) to suffer damage to its reputation or loss of profits through negative publicity.

Wal-Mart and Nike in particular have been frequent targets for advocacy groups that believe those corporations exploit their workers. Although some of these assertions may be unfounded or exaggerated, the courts generally have refused to consider them *defamatory* (a tort giving rise to a civil lawsuit). Most courts regard online attacks as expressions of opinion protected by the First Amendment. Even so, corporations often incur considerable expense in running marketing campaigns to thwart bad publicity and may even face legal costs if the allegations lead to litigation.

Image Is Everything The study of business ethics is concerned with the purposes of a business and how that business achieves those purposes. Thus, business ethics is concerned not only with the image of the business, but also with the impact that the business has on the environment, customers, suppliers, employees, and the global economy.

Unethical corporate decision making can negatively affect suppliers, consumers, the community, and society as a whole. It can also have a negative impact on the reputation of the company and the individuals who run that company. Hence, an in-depth understanding of business ethics is important to the long-run viability of any corporation today.

1-1c The Relationship of Law and Ethics

Because the law does not codify all ethical requirements, compliance with the law is not always sufficient to determine "right" behavior. Laws have to be general enough to apply in a variety of circumstances. Laws are broad in their purpose and their scope. They prohibit or require certain actions to avoid significant harm to society.

When two competing companies secretly agree to set prices on products, for instance, society suffers harm—typically, the companies will charge higher prices than they could if they continued to compete. This harm inflicted on consumers has negative consequences for the economy, and so colluding to set prices is an illegal activity. Similarly, when a company is preparing to issue stock, the law requires certain disclosures to potential investors. This requirement is meant to prevent harms that come

with uninformed investing. Such harms occurred in the 1920s and may have contributed to the stock market crash and the Great Depression.

Moral Minimum Compliance with the law is sometimes called the **moral minimum**. If people and entities

merely comply with the law, they are acting at the lowest ethical level society will tolerate. The study of ethics goes beyond those legal requirements to evaluate what is right for society. The following case illustrates some consequences of a businessperson's failure to meet the moral minimum.

Case 1.1



Scott v. Carpanzano

United States Court of Appeals, Fifth Circuit, 556 Fed.Appx. 288 (2014).

Background and Facts Rick Scott deposited \$2 million into an escrow account maintained by a company owned by Salvatore Carpanzano. Immediately after the deposit was made, in violation of the escrow agreement, the funds were withdrawn. When Scott was unable to recover his money, he filed a suit against Salvatore Carpanzano and others, including Salvatore's daughter Carmela Carpanzano. In the complaint, Scott made no allegations of acts or knowledge on Carmela's part.

Salvatore failed to cooperate with discovery and did not respond to attempts to contact him by certified mail, regular mail, or e-mail. Salvatore also refused to make an appearance in the court and did not finalize a settlement negotiated between the parties' attorneys. Carmela denied that she was involved in her father's business or the Scott transaction. The court found that the defendants had intentionally failed to respond to the litigation and issued a judgment for more than \$6 million in Scott's favor. The defendants appealed to the U.S. Court of Appeals for the Fifth Circuit.

In the Language of the Court

PER CURIAM [By the Whole Court].

* * * *

A willful default is an *intentional failure to respond to litigation*. The district court found that [the] Defendants willfully defaulted based on evidence that the Defendants were aware of the proceedings against them and that [their] attorneys were specifically instructed not to enter an appearance [participate] in this case. [Emphasis added.]

The evidence substantially supports the district court's finding as to Mr. Carpanzano. First, Mr. Carpanzano's first attorney withdrew [from the case] because Mr. Carpanzano failed to cooperate with the discovery process and refused to appear as requested and ordered. Second, * * * Mr. Carpanzano instructed his second set of attorneys to negotiate settlement of this matter but not to enter an appearance in the district court. Significantly, Mr. Carpanzano never denies this allegation. Third, * * * Mr. Carpanzano and his attorneys were well aware that the case was proceeding toward default and * * * were in communication with each other during this time. Fourth, * * * once final execution of settlement papers was at hand, Mr. Carpanzano also ceased communication with his second set of attorneys and did not finalize the settlement. Finally, other than ambiguously suggesting that a health condition (unsupported by any evidence of what the condition was) and absence from the country (unsupported by any evidence that electronic communication was not possible from that country) prevented him from defending this action, Mr. Carpanzano offers no real reason why he did not answer the * * * complaint.

* * * *

By contrast, the record does not support the district court's finding that * * * Ms. [Carmela] Carpanzano also willfully defaulted.

* * * Ms. Carpanzano repeatedly indicated that [she was] relying on Mr. Carpanzano * * * to make sure [her] interests were protected. Nothing in the record contradicts this assertion. While [her] reliance on Mr. Carpanzano acting with the attorneys he retained may have been negligent, it does not amount to an intentional failure to respond to litigation.

Case 1.1 Continued

* * * *

* * * [Furthermore] the * * * complaint * * * contains no factual allegations of acts or omissions on the part of Ms. Carpanzano. It does not allege that she ever was in contact with Scott, that she was in control of the * * * escrow account, or that she wrongfully transferred any funds out of the account. Nor does it allege any intent or knowledge on the part of Ms. Carpanzano * * *. Indeed, an examination of the complaint reveals that there is not a sufficient basis in the pleadings for the judgment * * * entered against Ms. Carpanzano.

The defenses presented by Ms. Carpanzano to the district court assert that she had no knowledge of the details of her father's business transactions, she did not personally enter into any contracts with Scott or seek to defraud him, and * * * she had limited involvement in the facts of this case.

* * * *

* * * Even if Scott were able to prove the entirety of the * * * complaint, we fail to see how it would justify a judgment * * * against Ms. Carpanzano.

Decision and Remedy *The U.S. Court of Appeals for the Fifth Circuit affirmed the judgment against Salvatore, but reversed the decision against Carmela. Scott had made no allegations of acts on Carmela's part.*

Critical Thinking

- **Ethical** *Are Salvatore's actions likely to affect his business's ability to profit in the long run? Discuss.*
- **Legal Environment** *Did Carmela Carpanzano meet the minimum acceptable standard for ethical business behavior? Explain.*

Ethical Requirements The study of ethics goes beyond legal requirements to evaluate what is right for society. Businesspersons thus must remember that an action that is legal is not necessarily ethical. For instance, a company's refusal to negotiate liability claims for alleged injuries because of a faulty product is legal. But it may not be ethical if the reason the business refuses to negotiate is to increase the injured party's legal costs and force the person to drop a legitimate claim.

Private Company Codes of Ethics Most companies attempt to link ethics and law through the creation of internal codes of ethics. Company codes are not law. Instead, they are rules that the company sets forth that it can also enforce (by terminating an employee who does not follow them, for instance). Codes of conduct typically outline the company's policies on particular issues and indicate how employees are expected to act.

■ **EXAMPLE 1.2** Google's code of conduct starts with the motto "Don't be evil." The code then makes general statements about how Google promotes integrity, mutual respect, and the highest standard of ethical business conduct. Google's code also provides specific rules on a number of issues, such as privacy, drugs and alcohol, conflicts of interest, co-worker relationships, and confidentiality.

It even has a dog policy. The company takes a stand against employment discrimination that goes further than the law requires—it prohibits discrimination based on sexual orientation, gender identity or expression, and veteran status. ■

Industry Ethical Codes Numerous industries have also developed their own codes of ethics. The American Institute of Certified Public Accountants (AICPA) has a comprehensive Code of Professional Conduct for the ethical practice of accounting. The American Bar Association has model rules of professional conduct for attorneys, and the American Nurses Association has a code of ethics that applies to nurses. These codes can give guidance to decision makers facing ethical questions.

Violation of an industry code may result in discipline of an employee or sanctions against a company from the industry organization. Remember, though, that these internal codes are not laws, so their effectiveness is determined by the commitment of the industry or company leadership to enforcing the codes.

■ **CASE IN POINT 1.3** National Football League (NFL) rules require footballs to be inflated to a minimum air pressure (pounds per square inch, or psi) as measured by the referees. This rule gained attention when the New

England Patriots played the Indianapolis Colts for the American Football Conference championship in early 2015. After Tom Brady, the Patriots quarterback, threw a pass that was intercepted, officials became suspicious that the football was underinflated. The game continued after NFL officials verified the psi in all the footballs, and the Patriots won.

Nevertheless, allegations continued that Brady and the Patriots had deflated balls during the game—a controversy popularly known as “deflategate.” The NFL performed an investigation, and after arbitration, the league announced that Brady would be suspended for four games. Brady appealed, and a federal district court vacated the arbitrator’s decision to suspend, but a federal appellate court reinstated Brady’s suspension in 2016. The reviewing court held that the arbitrator had grounds to suspend Brady for being generally aware that the team had intentionally released air from the game balls.² ■

“Gray Areas” in the Law Because it is often highly subjective and subject to change over time without any sort of formal process, ethics is less certain than law. But the law can also be uncertain. Numerous “gray areas” in the law make it difficult to predict with certainty how a court will apply a given law to a particular action. In addition, laws frequently change.

1-2 Business Ethics and Social Media

Most young people may think of social media—Facebook, Flickr, Instagram, Tumblr, Twitter, Pinterest, Google+, LinkedIn, VR, and the like—as simply ways to communicate rapidly. Businesses, though, often face ethical issues with respect to these same social media platforms.

1-2a Hiring Procedures

In the past, to learn about a prospective employee, an employer would ask the candidate’s former employers for references. Today, employers are likely to also conduct Internet searches to discover what job candidates have posted on their Facebook pages, blogs, and tweets.

On the one hand, job candidates may be judged by what they post on social media. On the other hand, though, they may be judged because they *do not*

participate in social media. Given that the vast majority of younger people do use social media, some employers have decided that the failure to do so raises a red flag. In either case, many people believe that judging a job candidate based on what she or he does outside the work environment is unethical.

1-2b The Use of Social Media to Discuss Work-Related Issues

Because so many Americans use social media daily, they often discuss work-related issues there. Numerous companies have strict guidelines about what is appropriate and inappropriate for employees to say when making posts on their own or others’ social media accounts. A number of companies have fired employees for such activities as criticizing other employees or managers through social media outlets. Until recently, such disciplinary measures were considered ethical and legal.

Responsibility of Employers Today, in contrast, a ruling by the National Labor Relations Board (NLRB—the federal agency that investigates unfair labor practices) has changed the legality of such actions. ■ **EXAMPLE 1.4** At one time, Costco’s social media policy specified that its employees should not make statements that would damage the company, harm another person’s reputation, or violate the company’s policies. Employees who violated these rules were subject to discipline and could be fired.

The NLRB ruled that Costco’s social media policy violated federal labor law, which protects employees’ right to engage in “concerted activities.” Employees can freely associate with each other and have conversations about common workplace issues without employer interference. This right extends to social media posts. Therefore, an employer cannot broadly prohibit its employees from criticizing the company or co-workers, supervisors, or managers via social media. ■

Responsibility of Employees While most of the discussion in this chapter concerns the ethics of business management, employee ethics is also an important issue. For instance, is it ethical for employees to make negative posts in social media about other employees or, more commonly, about managers? After all, negative comments about managers reflect badly on those managers, who often are reluctant to respond via social media to such criticism. Disgruntled employees may exaggerate the negative qualities of managers whom they do not like.

2. *National Football League Management Council v. National Football League Players Association*, 820 F.3d 527 (2d Cir. 2016).

Some may consider the decision by the National Labor Relations Board outlined in *Example 1.4* to be too lenient toward employees and too stringent toward management. There is likely to be an ongoing debate about how to balance employees' right to free expression against employers' right to prevent the spreading of inaccurate negative statements across the Internet.

1-3 Ethical Principles and Philosophies

As Dean Krehmeyer, executive director of the Business Roundtable's Institute for Corporate Ethics, once said, "Evidence strongly suggests being ethical—doing the right thing—pays." Even if ethics "pays," though, instilling ethical business decision making into the fabric of a business organization is no small task.

How do business decision makers decide whether a given action is the "right" one for their firms? What ethical standards should be applied? Broadly speaking, **ethical reasoning**—the application of morals and ethics to a situation—applies to businesses just as it does to individuals. As businesses make decisions, they must analyze their alternatives in a variety of ways, one of which is the ethical implications of each alternative.

Generally, the study of ethics is divided into two major categories—duty-based ethics and outcome-based ethics. **Duty-based ethics** is rooted in the idea that every person has certain duties to others, including both humans and the planet. **Outcome-based ethics** focuses on the impacts of a decision on society or on key *stakeholders*.

1-3a Duty-Based Ethics

Duty-based ethics focuses on the obligations of the corporation. It deals with standards for behavior that traditionally were derived from revealed truths, religious authorities, or philosophical reasoning. These standards involve concepts of right and wrong, duties owed, and rights to be protected. Corporations today often describe these values or duties in their mission statements or strategic plans. Some companies base their statements on a nonreligious rationale, while others derive their values from religious doctrine.

Religious Ethical Principles Nearly every religion has principles or beliefs about how one should treat others. In the Judeo-Christian tradition, which is the

dominant religious tradition in the United States, the Ten Commandments of the Old Testament establish these fundamental rules for moral action. The principles of the Muslim faith are set out in the Qur'an, and Hindus find their principles in the four Vedas.

Religious rules generally are absolute with respect to the behavior of their adherents. ■ **EXAMPLE 1.5** The commandment "Thou shalt not steal" is an absolute mandate for a person who believes that the Ten Commandments reflect revealed truth. Even a benevolent motive for stealing (such as Robin Hood's) cannot justify the act because the act itself is inherently immoral and thus wrong. ■

For businesses, religious principles can be a unifying force for employees or a rallying point to increase employee motivation. They can also present problems, however, because different owners, suppliers, employees, and customers may have different religious backgrounds. Taking an action based on religious principles, especially when those principles address socially or politically controversial topics, can lead to negative publicity and even to protests or boycotts.

Principles of Rights Another view of duty-based ethics focuses on basic rights. The principle that human beings have certain fundamental rights (to life, freedom, and the pursuit of happiness, for example) is deeply embedded in Western culture.

Those who adhere to this **principle of rights**, or "rights theory," believe that a key factor in determining whether a business decision is ethical is how that decision affects the rights of others. These others include the firm's owners, its employees, the consumers of its products or services, its suppliers, the community in which it does business, and society as a whole.

Conflicting Rights. A potential dilemma for those who support rights theory is that they may disagree on which rights are most important. When considering all those affected by a business decision to downsize a firm, for example, how much weight should be given to employees relative to shareholders? Which employees should be laid off first—those with the highest salaries or those who have worked there for less time (and have less seniority)? How should the firm weigh the rights of customers relative to the community, or employees relative to society as a whole?

Resolving Conflicts. In general, rights theorists believe that whichever right is stronger in a particular circumstance takes precedence. ■ **EXAMPLE 1.6** Murray

Chemical Corporation has to decide whether to keep a chemical plant in Utah open, thereby saving the jobs of a hundred and fifty workers, or shut it down. Closing the plant will avoid contaminating a river with pollutants that might endanger the health of tens of thousands of people. In this situation, a rights theorist can easily choose which group to favor because the value of the right to health and well-being is obviously stronger than the basic right to work. Not all choices are so clear-cut, however. ■

Kantian Ethical Principles Duty-based ethical standards may also be derived solely from philosophical reasoning. The German philosopher Immanuel Kant (1724–1804) identified some general guiding principles for moral behavior based on what he thought to be the fundamental nature of human beings. Kant believed that human beings are qualitatively different from other physical objects and are endowed with moral integrity and the capacity to reason and conduct their affairs rationally.

People Are Not a Means to an End. Based on this view of human beings, Kant said that when people are treated merely as a means to an end, they are being treated as the equivalent of objects and are being denied their basic humanity. For instance, a manager who treats subordinates as mere profit-making tools is less likely to retain motivated and loyal employees than a manager who respects employees. Management research has shown that, in fact, employees who feel empowered to share their thoughts, opinions, and solutions to problems are happier and more productive.

Categorical Imperative. When a business makes unethical decisions, it often rationalizes its action by saying that the company is “just one small part” of the problem or that its decision has had “only a small impact.” A central theme in Kantian ethics is that individuals should evaluate their actions in light of the consequences that would follow if everyone in society acted in the same way. This **categorical imperative** can be applied to any action.

■ **EXAMPLE 1.7** CHS Fertilizer is deciding whether to invest in expensive equipment that will decrease profits but will also reduce pollution from its factories. If CHS has adopted Kant’s categorical imperative, the decision makers will consider the consequences if every company invested in the equipment (or if no company did so). If the result would make the world a better place (less polluted), CHS’s decision would be clear. ■

1-3b Outcome-Based Ethics: Utilitarianism

In contrast to duty-based ethics, outcome-based ethics focuses on the consequences of an action, not on the nature of the action itself or on any set of preestablished moral values or religious beliefs. Outcome-based ethics looks at the impacts of a decision in an attempt to maximize benefits and minimize harms.

The premier philosophical theory for outcome-based decision making is **utilitarianism**, a philosophical theory developed by Jeremy Bentham (1748–1832) and modified by John Stuart Mill (1806–1873)—both British philosophers. “The greatest good for the greatest number” is a paraphrase of the major premise of the utilitarian approach to ethics.

Cost-Benefit Analysis Under a utilitarian model of ethics, an action is morally correct, or “right,” when, among the people it affects, it produces the greatest amount of good for the greatest number or creates the least amount of harm for the fewest people. When an action affects the majority adversely, it is morally wrong. Applying the utilitarian theory thus requires the following steps:

1. A determination of which individuals will be affected by the action in question.
2. A **cost-benefit analysis**, which involves an assessment of the negative and positive effects of alternative actions on these individuals.
3. A choice among alternative actions that will produce maximum societal utility (the greatest positive net benefits for the greatest number of individuals).

Thus, if expanding a factory would provide hundreds of jobs but generate pollution that could endanger the lives of thousands of people, a utilitarian analysis would find that saving the lives of thousands creates greater good than providing jobs for hundreds.

Problems with the Utilitarian Approach There are problems with a strict utilitarian analysis. In some situations, an action that produces the greatest good for the most people may not seem to be the most ethical. ■ **EXAMPLE 1.8** Phazim Company is producing a drug that will cure a disease in 85 percent of patients, but the other 15 percent will experience agonizing side effects and a horrible, painful death. A quick utilitarian analysis would suggest that the drug should be produced and marketed because the majority of patients will

benefit. Many people, however, have significant concerns about manufacturing a drug that will cause such harm to anyone. ■

1-3c Corporate Social Responsibility

In pairing duty-based concepts with outcome-based concepts, strategists and theorists developed the idea of the corporate citizen. **Corporate social responsibility (CSR)** combines a commitment to good citizenship with a commitment to making ethical decisions, improving society, and minimizing environmental impact.

CSR is a relatively new concept in the history of business, but a concept that becomes more important every year. Although CSR is not imposed on corporations by law, it does involve a commitment to self-regulation in a way that attends to the text and intent of the law as well as to ethical norms and global standards. A survey of U.S. executives undertaken by the Boston College Center for Corporate Citizenship found that more than 70 percent of those polled agreed that corporate citizenship must be treated as a priority. More than 60 percent said that good corporate citizenship added to their companies' profits.

CSR can be a successful strategy for companies, but corporate decision makers must not lose track of the two descriptors in the title: *corporate* and *social*. The company must link the responsibility of citizenship with the strategy and key principles of the business. Incorporating both the social and the corporate components of CSR and making ethical decisions can help companies grow and prosper. CSR is most successful when a company undertakes activities that are significant and related to its business operations.

The Social Aspects of CSR Because business controls so much of the wealth and power in this country, business has a responsibility to use that wealth and power in socially beneficial ways. Thus, the social aspect requires that corporations demonstrate that they are promoting goals that society deems worthwhile and are moving toward solutions to social problems. Companies may be judged on how much they donate to social causes, as well as how they conduct their operations with respect to employment discrimination, human rights, environmental concerns, and similar issues.

Some corporations publish annual social responsibility reports, which may also be called corporate sustainability (referring to the capacity to endure) or citizenship reports. ■ **EXAMPLE 1.9** The software company

Symantec Corporation issues corporate responsibility reports to demonstrate its focus on critical environmental, social, and governance issues. In its 2014 report, Symantec pointed out that 88 percent of facilities it owns or leases on a long-term basis are certified as environmentally friendly by the LEED program. LEED stands for Leadership in Energy and Environmental Design. Certification requires the achievement of high standards for energy efficiency, material usage in construction, and other environmental qualities. ■

The Corporate Aspects of CSR Arguably, any socially responsible activity will benefit a corporation. A corporation may see an increase in goodwill from the local community for creating a park, for instance. A corporation that is viewed as a good citizen may see an increase in sales.

At times, the benefit may not be immediate. Constructing a new plant that meets the high LEED standards may cost more initially. Nevertheless, over the life of the building, the savings in maintenance and utilities may more than make up for the extra cost of construction.

Surveys of college students about to enter the job market confirm that young people are looking for socially responsible employers. Socially responsible activities may thus cost a corporation now, but may lead to more impressive and more committed employees. Corporations that engage in meaningful social activities retain workers longer, particularly younger ones.

■ **EXAMPLE 1.10** Pacific Gas and Electric (PG&E) in California sends its employees out on Earth Day to help clean and restore state parks. PG&E also provides free solar panels for new Habitat for Humanity homes and donates food to the needy. LinkedIn employees participate in an “InDay” every month to donate time and resources to the community. Zappos donates large amounts of its goods to charities and pays its employees for time off if they are volunteering. ■

Stakeholders One view of CSR stresses that corporations have a duty not just to shareholders, but also to other groups affected by corporate decisions—called **stakeholders**. The rationale for this “stakeholder view” is that, in some circumstances, one or more of these other groups may have a greater stake in company decisions than the shareholders do.

Under this approach, a corporation considers the impact of its decisions on its employees, customers, creditors, suppliers, and the community in which it operates.

Stakeholders could also include advocacy groups such as environmental groups and animal rights groups. To avoid making a decision that may be perceived as unethical and result in negative publicity or protests, a corporation should consider the impact of its decision on the stakeholders.

The most difficult aspect of the stakeholder analysis is determining which group's interests should receive greater weight if the interests conflict. For instance, companies that are struggling financially sometimes lay off workers to reduce labor costs. But in recent years, some corporations have given greater weight to employees' interests and have found ways to avoid slashing their workforces. Companies finding alternatives to layoffs included Dell (extended unpaid holidays), Cisco Systems (four-day end-of-year shutdowns), Motorola (salary cuts), and Honda (voluntary unpaid vacation time).

1-4 Making Ethical Business Decisions

Even if officers, directors, and others in a company want to make ethical decisions, it is not always clear what is ethical in a given situation. Thinking beyond things that are easily measured, such as profits, can be challenging. Although profit projections are not always accurate, they are more objective than considering the personal impacts of decisions on employees, shareholders, customers, and the community. But this subjective component of decision making potentially has a great potential influence on a company's profits.

Companies once considered leaders in their industry, such as Enron and the worldwide accounting firm Arthur Andersen, were brought down by the unethical behavior of a few. A two-hundred-year-old British investment banking firm, Barings Bank, was destroyed by the actions of one employee and a few of his friends. Clearly, ensuring that all employees get on the ethical business decision-making "bandwagon" is crucial in today's fast-paced world.

Individuals entering the global corporate community, even in entry-level positions, must be prepared to make hard decisions. Sometimes, there is no "good" answer to the questions that arise. Therefore, it is important to have tools to help in the decision-making process and to create a framework for organizing those tools. Business decisions can be complex and may involve legal concerns, financial questions, possibly health and safety concerns, and ethical components.

1-4a A Systematic Approach

Organizing the ethical concerns and issues and approaching them systematically can help a businessperson eliminate various alternatives and identify the strengths and weaknesses of the remaining alternatives. Ethics consultant Leonard H. Bucklin of Corporate-Ethics.US™ has devised a procedure that he calls Business Process Pragmatism™. It involves five steps:

Step 1: Inquiry. First, the decision maker must understand the problem. This step involves identifying the parties involved (the stakeholders) and collecting the relevant facts. Once the ethical problem or problems are clarified, the decision maker lists any relevant legal and ethical principles that will guide the decision.

Step 2: Discussion. In this step, the decision maker lists possible actions. The ultimate goals for the decision are determined, and each option is evaluated using the laws and ethical principles listed in Step 1.

Step 3: Decision. In this step, those participating in the decision making work together to craft a consensus decision or consensus plan of action for the corporation.

Step 4: Justification. In this step, the decision maker articulates the reasons for the proposed action or series of actions. Generally, these reasons should come from the analysis done in Step 3. This step essentially results in documentation to be shared with stakeholders explaining why the proposal is an ethical solution to the problem.

Step 5: Evaluation. This final step occurs once the decision has been made and implemented. The solution should be analyzed to determine if it was effective. The results of this evaluation may be used in making future decisions.

1-4b The Importance of Ethical Leadership

Talking about ethical business decision making is meaningless if management does not set standards. Furthermore, managers must apply the same standards to themselves as they do to the company's employees. See this chapter's *Digital Update* feature for a discussion of an ethical dilemma that has arisen from the increased use of digital technology by employees after work hours.

Attitude of Top Management One of the most important ways to create and maintain an ethical workplace is for top management to demonstrate its commitment to ethical decision making. A manager who is not totally committed to an ethical workplace rarely succeeds in creating one. Management's behavior, more than

DIGITAL UPDATE

Should Employees Have a “Right of Disconnect”?

Almost all jobs today involve digital technology, whether it be e-mail, Internet access, or smartphone use. Most employees, when interviewed, say that digital technology increases their productivity and flexibility.

The downside is what some call an “electronic leash”—meaning that employees are constantly connected and end up working when they are not “at work.” Over one-third of full-time workers, for example, say that they frequently check e-mails outside normal working hours.



This definition was extended to off-duty work if such work is an “integral and indispensable part of [employees’] activities.”^b

Today’s modern digital connectivity raises issues about the definition of *work*. Employees at several major companies, including Black & Decker, T-Mobile, and Verizon, have sued for unpaid overtime related to smartphone use.

In another case, a police sergeant has sued the city of Chicago, claiming that he should have been paid overtime for hours spent using his personal digital assistant (PDA).^c The police department issues PDAs to officers and requires them to respond to work-related text messages, e-mails, and voice mails not only while on duty, but also while off duty. Off-duty responses are not compensated by the city.

Not All Employees Demand the “Right to Disconnect”

According to a recent Gallup poll, 79 percent of full-time employees had either strongly positive or somewhat positive views of using computers, e-mail, tablets, and smartphones to work remotely outside of normal business hours. According to the same poll, 17 percent of them report “better overall lives” because of constant online connectivity with their work. Finally, working remotely after business hours apparently does not necessarily result in additional work-related stress.

Do Workers Have the Right to Disconnect?

Because the boundaries between being “at work” and being “at leisure” can be so hazy, some labor unions in other countries have attempted to pass rules that allow employees to disconnect from e-mail and other work-related digital communication during nonworking hours. For instance, a French labor union representing high-tech workers signed an agreement with a large business association recognizing a “right of disconnecting.” In Germany, Volkswagen and BMW no longer forward e-mail to staff from company servers after the end of the workday. Other German firms have declared that workers are not expected to check e-mail on weekends and holidays. The government is considering legislating such restrictions nationwide.

The Thorny Issue of Overtime and the Fair Labor Standards Act

Payment for overtime work is strictly regulated under the Fair Labor Standards Act (FLSA). According to the United States Supreme Court, in this context, *work* is “physical or mental exertion (whether burdensome or not) controlled or required by the employer and pursued necessarily for the benefit of the employer and his business.”^a

Critical Thinking *From an ethical point of view, is there any difference between calling subordinates during off hours for work-related questions and sending them e-mails or text messages?*

a. *Tennessee Coal, Iron & R. Co. v. Muscoda Local No. 123*, 321 U.S. 590, 64 S.Ct. 698, 8 L.Ed. 949 (1944). Although Congress later passed a statute that superseded the holding in this case, the statute gave the courts broad authority to interpret the FLSA’s definition of *work*. 29 U.S.C. Section 251(a). See *Integrity Staffing Solutions, Inc. v. Busk*, ___ U.S. ___, 135 S.Ct. 513, 190 L.Ed.2d 410 (2014).

b. *Steiner v. Mitchell*, 350 U.S. 247, 76 S.Ct. 330, 100 L.Ed. 267 (1956).

c. *Allen v. City of Chicago*, 2014 WL 5461856 (N.D.Ill. 2014).

anything else, sets the ethical tone of a firm. Employees take their cues from management.

Managers have found that discharging even one employee for ethical reasons has a tremendous impact as a deterrent to unethical behavior in the workplace. This is true even if the company has a written code of ethics.

If management does not enforce the company code, the code is essentially nonexistent.

The administration of a university may have had a similar concept in mind in the following case when it applied the school’s professionalism standard to a student who had engaged in serious misconduct.

Case 1.2

Al-Dabagh v. Case Western Reserve University

United States Court of Appeals, Sixth Circuit, 777 F.3d 355 (2015).



Background and Facts The curriculum at Case Western Reserve University School of Medicine identifies nine “core competencies.” At the top of the list is professionalism, which includes “ethical, honest, responsible and reliable behavior.” The university’s Committee on Students determines whether a student has met the professionalism requirements.

Amir Al-Dabagh enrolled at the school and did well academically. But he sexually harassed fellow students, often asked an instructor not to mark him late for class, received complaints from hospital staff about his demeanor, and was convicted of driving while intoxicated. The Committee on Students unanimously refused to certify him for graduation and dismissed him from the university.

He filed a suit in a federal district court against Case Western, alleging a breach of good faith and fair dealing. The court ordered the school to issue a diploma. Case Western appealed.

In the Language of the Court

SUTTON, Circuit Judge.

*** Case Western’s student handbook *** makes clear that the only thing standing between Al-Dabagh and a diploma is the Committee on Students’ finding that he lacks professionalism. Unhappily for Al-Dabagh, that is an academic judgment. And *we can no more substitute our personal views for the Committee’s when it comes to an academic judgment than the Committee can substitute its views for ours when it comes to a judicial decision.* [Emphasis added.]

*** *The Committee’s professionalism determination is an academic judgment. That conclusion all but resolves this case. We may overturn the Committee only if it substantially departed from accepted academic norms when it refused to approve Al-Dabagh for graduation.* And given Al-Dabagh’s track record—one member of the Committee does not recall encountering another student with Al-Dabagh’s “repeated professionalism issues” in his quarter century of experience—we cannot see how it did. [Emphasis added.]

To the contrary, Al-Dabagh insists: The Committee’s decision was a “punitive disciplinary measure” that had nothing to do with academics. *** His argument fails to wrestle with the prominent place of professionalism in the university’s academic curriculum—which itself is an academic decision courts may not lightly disturb.

Even if professionalism is an academic criterion, Al-Dabagh persists that the university defined it too broadly. As he sees it, the only professional lapses that matter are the ones linked to academic performance. That is not how we see it or for that matter how the medical school sees it. That many professionalism-related cases involve classroom incidents does not establish that only classroom incidents are relevant to the professionalism inquiry ***. Our own standards indicate that professionalism does not end at the courtroom door. Why should hospitals operate any differently? As for the danger that an expansive view of professionalism might forgive, or provide a cloak for, arbitrary or discriminatory behavior, we see no such problem here. Nothing in the record suggests that the university had impermissible motives or acted in bad faith in this instance. And nothing in our deferential standard prevents us from invalidating genuinely objectionable actions when they occur.

Decision and Remedy *The U.S. Court of Appeals for the Sixth Circuit reversed the lower court’s order to issue a diploma to Al-Dabagh. The federal appellate court found nothing to indicate that Case Western had “impermissible motives,” acted in bad faith, or dealt unfairly with Al-Dabagh.*

Critical Thinking

- **What If the Facts Were Different?** *Suppose that Case Western had tolerated Al-Dabagh’s conduct and awarded him a diploma. What impact might that had on other students at the school? Why?*

Behavior of Owners and Managers Certain types of behavior on the part of managers and owners contribute to unethical behavior among employees. Managers who set unrealistic production or sales goals increase the probability that employees will act unethically. If a sales quota can be met only through high-pressure, unethical sales tactics, employees will try to act “in the best interest of the company” and will continue to behave unethically. A manager who looks the other way when she or he knows about an employee’s unethical behavior also sets an example—one indicating that ethical transgressions will be accepted.

Business owners and managers sometimes take more active roles in fostering unethical and illegal conduct. This sort of misbehavior can have negative consequences for the owners and managers and their business. Not only can a court sanction them, but it can also issue an injunction that prevents them from engaging in similar patterns of conduct in the future.

■ **CASE IN POINT 1.11** John Robert Johnson, Jr., took a truck that needed repair along with its fifteen-ton trailer to Bubba Shaffer, doing business as Shaffer’s Auto and Diesel Repair, LLC. The truck was supposedly fixed,

and Johnson paid the bill, but the truck continued to leak oil and water. Johnson returned the truck to Shaffer, who again claimed to have fixed the problem. Johnson paid the second bill. The problems with the truck continued, however, so Johnson returned the truck and trailer to Shaffer a third time.

Johnson was given a verbal estimate of \$1,000 for the repairs, but Shaffer ultimately sent an invoice for \$5,863. Johnson offered to settle for \$2,480, the amount of the initial estimate (\$1,000), plus the costs of parts and shipping. Shaffer refused the offer and would not return Johnson’s truck or trailer until full payment was made. Shaffer retained possession for almost four years and also charged Johnson a storage fee of \$50 a day and 18 percent interest on the \$5,863. Johnson sued for unfair trade practices and won. The court awarded him \$3,500 in damages plus attorneys’ fees and awarded Shaffer \$1,000 (the amount of his estimate).³ ■

The following case further demonstrates the types of situations that can occur when management demonstrates a lack of concern about ethics.

3. *Johnson Construction Co. v. Shaffer*, 87 So.3d 203 (La.App. 2012).

Case Analysis 1.3

Moseley v. Pepco Energy Services, Inc.

United States District Court, District of New Jersey, 2011 WL 1584166 (2011).

In the Language of the Court

Joseph H. RODRIGUEZ, District Judge.

*** Plaintiff Moseley is an employee of Defendant Pepco Energy Services, Inc. (“PES”). He has been employed by PES or its corporate predecessors for over twenty-five years. PES, a subsidiary of Defendant Pepco Holdings, Inc. (“PHI”), provides deregulated energy and energy-related services for residential, small business, and large commercial customers.

In 1998, Thomas Herzog held the position of Vice President of CTS. *** In or around 2002, CTS merged with Potomac Electric Power Company, Inc., and each company became a subsidiary of PHI. Following the merger, according to Plaintiff, he continued to work for

PHI, still as Maintenance Manager at Midtown Thermal, until December 31, 2009.

Following the 2002 merger with PHI, employees were required to complete an annual ethics survey. By March of 2007, Plaintiff and two co-workers had discussed their respective observations of Herzog’s conduct, which they deemed questionable and possibly unethical. Specifically, they felt that Herzog improperly used company assets and improperly hired immediate family members and friends who did not appear on the payroll. The three decided to disclose this information on PHI’s annual “Ethics Survey.”

The three planned to reveal that Herzog employed his daughter, Laurie, as his

secretary in the summer of 2005 and the beginning of 2006 without posting the position first and in violation of PHI’s anti-nepotism policy.

Next, Herzog hired his girlfriend’s daughter as his secretary after his daughter had gone back to school. Plaintiff believed this was in violation of Company policy because the position again was not posted. Herzog also hired his son as a project manager, again through a third party independent contractor, Walter Ratai. Plaintiff thought this was wrong because (1) Herzog circumvented the Company’s hiring process, (2) it violated Company policy, and (3) Herzog’s son was being paid \$75.00/hr, which was more than Plaintiff was making. ***



Case 1.3 Continues

Case 1.3 Continued

In addition, Plaintiff had learned that Herzog was improperly using the Company's Eagles' tickets for personal use. Finally, Herzog had leased a new SUV with Company funds, but which was not approved by the Company.

[After the surveys were completed, an] investigation ensued. Following the investigation, effective on or about May 10, 2007, Herzog was escorted out of the building. *** On March 8, 2008, Plaintiff received his annual performance evaluation ***; for the first time in twenty-three years, Plaintiff's performance review was negative. Plaintiff feels that this negative performance review was a further act of retaliation for his disclosure of Herzog's conduct.

On or about June 11, 2008 the Plant/Operations Manager position was posted ***. Plaintiff applied for the position, but it was offered to [another person]. Plaintiff alleges that he "was not promoted to the position of Plant/Operations Manager despite his experience performing the job for the previous two and a half years, qualifications for same and seniority, as a direct and proximate result of his prior complaints and/or disclosures regarding the Herzog illegal conduct and activities."

The New Jersey Legislature enacted the Conscientious Employee Protection Act (CEPA) to "protect and encourage employees to report illegal or unethical workplace activities." *** CEPA prohibits a New Jersey employer from taking "retaliatory action" against an employee who objects to "any activity, policy or practice which the employee reasonably believes" is in violation of applicable law. *** "To prevail on a claim under

this provision, a plaintiff must establish that: (1) he reasonably believed that [the complained-of] conduct was violating a law or rule or regulation promulgated pursuant to law; (2) he objected to the conduct; (3) an adverse employment action was taken against him; and (4) a causal connection exists between the whistleblowing activity and the adverse employment action.

The first element of the *prima facie* case [a case sufficient to be sent to the jury] under CEPA is that the Plaintiff reasonably believed that the complained-of conduct (1) was violating a "law, rule, or regulation promulgated pursuant to law, including any violation involving deception of, or misrepresentation to, any shareholder, investor, client, patient, customer, employee, former employee, retiree or pensioner of the employer or any governmental entity"; or "(2) is fraudulent or criminal, including any activity, policy or practice of deception or misrepresentation which the employee reasonably believes may defraud any shareholder, investor, client, patient, customer, employee, former employee, retiree or pensioner of the employer or any governmental entity."

Although Defendants have argued that Plaintiff merely disclosed a violation of Company policy, Moseley has testified that in March 2007, he reported what he believed to be "unethical conduct, misappropriation of company funds, and theft" by his direct supervisor. *** *Moreover, a plaintiff need not demonstrate that there was a violation of the law or fraud, but instead that he "reasonably believed" that to be the case.* The facts in this case support an objectively reasonable belief that a violation of law or

fraudulent conduct was being committed by Plaintiff's supervisor. [Emphasis added.]

Regarding the causal connection between Plaintiff's whistleblowing activity and the negative adverse employment actions taken against him, Plaintiff stresses that he was employed by the Defendants for twenty-five years without a negative employment evaluation or any form of discipline until immediately after he disclosed the wrongful conduct of his supervisor. Not only did Plaintiff then receive a negative performance evaluation, but the posted position of Plant Manager was given to [another], despite [the other's] alleged past negative history and despite that Plaintiff asserts he had been acting in that job for over two years. Plaintiff contends that this is sufficient evidence of pretext.

The Court is unable to find as a matter of law that Defendants' inferences prevail or that a jury could not reasonably adopt a contrary inference of retaliation. There are questions of fact as to how much the individuals responsible for Plaintiff's negative performance evaluations knew about Plaintiff's complaints. "[A] finding of the required causal connection may be based solely on circumstantial evidence that the person ultimately responsible for an adverse employment action was aware of an employee's whistle-blowing activity." Because jurors may infer a causal connection from the surrounding circumstances, as well as temporal proximity, the Court will not grant summary judgment. [Emphasis added.]

IT IS ORDERED on this 26th day of April, 2011 that Defendants' motion for summary judgment is hereby DENIED.

Legal Reasoning Questions

1. Using duty-based ethical principles, what facts or circumstances in this case would lead Moseley to disclose Herzog's behavior?
2. Using outcome-based ethical principles, what issues would Moseley have to analyze in making the decision to report Herzog's behavior? What would be the risks to Moseley? The benefits?
3. Under the Business Process Pragmatism™ steps, what alternatives might Moseley have had in this situation?

The Sarbanes-Oxley Act Congress enacted the Sarbanes-Oxley Act⁴ to help reduce corporate fraud and unethical management decisions. The act requires companies to set up confidential systems so that employees and others can “raise red flags” about suspected illegal or unethical auditing and accounting practices.

Some companies have implemented online reporting systems to accomplish this goal. In one such system, employees can click on an on-screen icon that anonymously links them with NAVEX Global, an organization based in Oregon. Through NAVEX Global, employees can report suspicious accounting practices, sexual harassment, and other possibly unethical behavior. NAVEX, in turn, alerts management personnel or the audit committee at the designated company to the possible problem.

1-5 Global Business Ethics

Just as different religions have different moral codes, different countries, regions, and even states have different ethical expectations and priorities. Some of these differences are based in religious values, whereas others are cultural in nature. Such differences make it even more difficult to determine what is ethical in a particular situation. For instance, in certain countries the consumption of alcohol is forbidden for religious reasons. It would be considered unethical for a U.S. business to produce alcohol in those countries and employ local workers to assist in alcohol production.

International transactions often involve issues related to employment and financing. Congress has addressed some of these issues, not eliminating the ethical components but clarifying some of the conflicts between the ethics of the United States and the ethics of other nations. For instance, the Civil Rights Act and the Foreign Corrupt Practices Act have clarified the U.S. ethical position on employment issues and bribery in foreign nations. (Other nations, including Mexico, have also enacted laws that prohibit bribery.)

1-5a Monitoring the Employment Practices of Foreign Suppliers

Many businesses contract with companies in developing nations to produce goods, such as shoes and clothing, because the wage rates in those nations are significantly lower than those in the United States. But what if one of those contractors hires women and children at

below-minimum-wage rates or requires its employees to work long hours in a workplace full of health hazards? What if the company’s supervisors routinely engage in workplace conduct that is offensive to women? What if plants located abroad routinely violate labor and environmental standards?

■ **EXAMPLE 1.12** Pegatron Corporation, a company based in China, manufactures and supplies parts to Apple, Inc., for iPads and other Apple products. After an explosion at a Pegatron factory in Shanghai, allegations surfaced that the conditions at the factory violated labor and environmental standards. Similar allegations were made about other Apple suppliers.

Apple started to evaluate practices at companies in its supply chain and to communicate its ethics policies to them. Its audits revealed numerous violations. Apple released a list of its suppliers for the first time and issued a lengthy “Supplier Responsibility Report” detailing supplier practices. Numerous facilities had withheld worker pay as a disciplinary measure. Some had falsified pay records and forced workers to use machines without safeguards. Others had engaged in unsafe environmental practices, such as dumping wastewater on neighboring farms. Apple terminated its relationship with one supplier and turned over its findings to the Fair Labor Association for further inquiry. ■

Given today’s global communications network, few companies can assume that their actions in other nations will go unnoticed by “corporate watch” groups that discover and publicize unethical corporate behavior. As a result, U.S. businesses today usually take steps to avoid such adverse publicity—either by refusing to deal with certain suppliers or by arranging to monitor their suppliers’ workplaces to make sure that the employees are not being mistreated.

1-5b The Foreign Corrupt Practices Act

Another ethical problem in international business dealings has to do with the legitimacy of certain side payments to government officials. In the United States, the majority of contracts are formed within the private sector. In many foreign countries, however, government officials make the decisions on most major construction and manufacturing contracts because of extensive government regulation and control over trade and industry.

Side payments to government officials in exchange for favorable business contracts are not unusual in such countries, nor have they been considered unethical. In the past, U.S. corporations doing business in these nations largely followed the dictum “When in Rome, do as the Romans do.”

In the 1970s, however, the U.S. media uncovered a number of business scandals involving large side

4. 15 U.S.C. Sections 7201 *et seq.*

payments by U.S. corporations to foreign representatives for the purpose of securing advantageous international trade contracts. In response to this unethical behavior, Congress passed the Foreign Corrupt Practices Act⁵ (FCPA), which prohibits U.S. businesspersons from bribing foreign officials to secure beneficial contracts.

Prohibition against the Bribery of Foreign Officials The first part of the FCPA applies to all U.S. companies and their directors, officers, shareholders, employees, and agents. This part prohibits the bribery of most officials of foreign governments if the purpose of the payment is to motivate the official to act in his or her official capacity to provide business opportunities.

The FCPA does not prohibit payments made to minor officials whose duties are ministerial. A ministerial action is a routine activity, such as the processing of paperwork, with little or no discretion involved in the action. These payments are often referred to as “grease,” or facilitating payments. They are meant to accelerate the performance of administrative services that might otherwise be carried out at a slow pace. Thus, for instance, if a firm makes a payment to a minor official to speed up an import licensing process, the firm has not violated the FCPA.

Generally, the act, as amended, permits payments to foreign officials if such payments are lawful within the foreign country. Payments to private foreign companies or other third parties are permissible—unless the U.S. firm knows that the payments will be passed on to a foreign government in violation of the FCPA. The U.S. Department of Justice also uses the FCPA to prosecute foreign companies suspected of bribing officials outside the United States.

Accounting Requirements In the past, bribes were often concealed in corporate financial records. Thus, the second part of the FCPA is directed toward accountants.

5. 15 U.S.C. Sections 78dd-1 *et seq.*

All companies must keep detailed records that “accurately and fairly” reflect their financial activities. Their accounting systems must provide “reasonable assurance” that all transactions entered into by the companies are accounted for and legal. These requirements assist in detecting illegal bribes. The FCPA prohibits any person from making false statements to accountants or false entries in any record or account.

■ **CASE IN POINT 1.13** Noble Corporation, an international provider of offshore drilling services and equipment, was operating some drilling rigs offshore in Nigeria. Mark Jackson and James Ruehlen were officers at Noble. The U.S. government accused Noble of bribing Nigerian government officials and charged Jackson and Ruehlen individually with violating the FCPA’s accounting provisions. Jackson and Ruehlen allegedly assisted in the bribery because they repeatedly allowed allegedly illegal payments to be posted on Noble’s books as legitimate operating expenses.⁶ ■

Penalties for Violations The FCPA provides that business firms that violate the act may be fined up to \$2 million. Individual officers or directors who violate the FCPA may be fined up to \$100,000 (the fine cannot be paid by the company) and may be imprisoned for up to five years. These statutory amounts can be significantly increased under the Alternative Fines Act⁷ (up to twice the amount of any gain that the defendant obtained by making the corrupt payment).

Today, the U.S. government is actively seeking out violators and has around 150 FCPA investigations going on at any given time. In recent years, a high percentage of the total fines imposed by the Department of Justice have come from FCPA cases.

6. *S.E.C. v. Jackson*, 908 F.Supp.2d 834 (S.D.Tex.—Houston Div. 2012).

7. 18 U.S.C. Section 3571.

Reviewing: Business Ethics

James Stilton is the chief executive officer (CEO) of RightLiving, Inc., a company that buys life insurance policies at a discount from terminally ill persons and sells the policies to investors. RightLiving pays the terminally ill patients a percentage of the future death benefit (usually 65 percent) and then sells the policies to investors for 85 percent of the value of the future benefit. The patients receive the cash to use for medical and other expenses. The investors are “guaranteed” a positive return on their investment, and RightLiving profits on the difference between the purchase and sale prices. Stilton is aware that some sick patients might obtain insurance policies through fraud (by not revealing the illness on the insurance application). Insurance companies that discover this will cancel the policy and refuse to pay.

Stilton believes that most of the policies he has purchased are legitimate, but he knows that some probably are not. Using the information presented in this chapter, answer the following questions.

1. Would a person who adheres to the principle of rights consider it ethical for Stilton not to disclose the potential risk of cancellation to investors? Why or why not?
2. Using Immanuel Kant's categorical imperative, are the actions of RightLiving, Inc., ethical? Why or why not?
3. Under utilitarianism, are Stilton's actions ethical? Why or why not? What difference does it make if most of the policies are legitimate?
4. Using the Business Process Pragmatism™ steps discussed in this chapter, discuss the decision process Stilton should use in deciding whether to disclose the risk of fraudulent policies to potential investors.

Debate This . . . *Executives in large corporations are ultimately rewarded if their companies do well, particularly as evidenced by rising stock prices. Consequently, should we let those who run corporations decide what level of negative side effects of their goods or services is "acceptable"?*

Terms and Concepts

business ethics 2	duty-based ethics 7	principle of rights 7
categorical imperative 8	ethical reasoning 7	stakeholders 9
corporate social responsibility (CSR) 9	ethics 2	triple bottom line 2
cost-benefit analysis 8	moral minimum 4	utilitarianism 8
	outcome-based ethics 7	

Issue Spotters

1. Acme Corporation decides to respond to what it sees as a moral obligation to correct for past discrimination by adjusting pay differences among its employees. Does this raise an ethical conflict between Acme and its employees? Between Acme and its shareholders? Explain your answers. (See *Making Ethical Business Decisions*.)
 2. Delta Tools, Inc., markets a product that under some circumstances is capable of seriously injuring consumers. Does Delta have an ethical duty to remove this product from the market, even if the injuries result only from misuse? Why or why not? (See *Making Ethical Business Decisions*.)
- **Check your answers to the Issue Spotters against the answers provided in Appendix B at the end of this text.**

Business Scenarios

1–1. Business Ethics. Jason Trevor owns a commercial bakery in Blakely, Georgia, that produces a variety of goods sold in grocery stores. Trevor is required by law to perform internal tests on food produced at his plant to check for contamination. On three occasions, the tests of food products containing peanut butter were positive for salmonella contamination. Trevor was not required to report the results to U.S. Food and Drug Administration officials, however, so he did not. Instead, Trevor instructed his employees to simply repeat the

tests until the results were negative. Meanwhile, the products that had originally tested positive for salmonella were eventually shipped out to retailers.

Five people who ate Trevor's baked goods that year became seriously ill, and one person died from a salmonella infection. Even though Trevor's conduct was legal, was it unethical for him to sell goods that had once tested positive for salmonella? Why or why not? (See *Business Ethics*.)

Business Case Problems

1-2. Spotlight on Pfizer, Inc.—Corporate Social Responsibility.



Methamphetamine (meth) is an addictive drug made chiefly in small toxic labs (STLs) in homes, tents, barns, or hotel rooms. The manufacturing process is dangerous and often results in explosions, burns, and toxic fumes. Government entities spend time and resources to find and destroy STLs, imprison meth dealers and users, treat addicts, and provide services for affected families. Meth cannot be made without ingredients that are also used in cold and allergy medications. Arkansas has one of the highest numbers of STLs in the United States. To recoup the costs of fighting the meth epidemic, twenty counties in Arkansas filed a suit against Pfizer, Inc., which makes cold and allergy medications. What is Pfizer's ethical responsibility here, and to whom is it owed? Why? [*Ashley County, Arkansas v. Pfizer, Inc.*, 552 F.3d 659 (8th Cir. 2009)] (See *Ethical Principles and Philosophies*.)

1-3. Business Case Problem with Sample Answer—Online Privacy.



Facebook, Inc., launched a program called “Beacon” that automatically updated the profiles of users on Facebook’s social networking site when those users had any activity on Beacon “partner” sites. For example, one partner site was Blockbuster.com. When a user rented or purchased a movie through Blockbuster.com, the user’s Facebook profile would be updated to share the purchase. The Beacon program was set up as a default setting, so users never consented to the program, but they could opt out. What are the ethical implications of an opt-in program versus an opt-out program in social media? [*Lane v. Facebook, Inc.*, 696 F.3d 811 (9th Cir. 2011)] (See *Business Ethics and Social Media*.)

- For a sample answer to Problem 1-3, go to Appendix C at the end of this text.

1-4. Business Ethics on a Global Scale. After the fall of the Soviet Union, the new government of Azerbaijan began converting certain state-controlled industries to private ownership. Ownership in these companies could be purchased through a voucher program. Frederic Bourke, Jr., and Viktor Kozeny wanted to purchase the Azerbaijani oil company, SOCAR, but it was unclear whether the Azerbaijani president would allow SOCAR to be put up for sale. Kozeny met with one of the vice presidents of SOCAR (who was also the son of the president of Azerbaijan) and other Azerbaijani leaders to discuss the sale of SOCAR. To obtain their cooperation, Kozeny set up a series of parent and subsidiary companies through which the Azerbaijani leaders would eventually receive two-thirds of the SOCAR profits without ever investing any of their own funds. In return, the Azerbaijani leaders would attempt to use their influence to convince the president to put SOCAR up for sale. Assume that Bourke and Kozeny are operating out of a U.S. company. Discuss the ethics of this scheme, both in terms of the Foreign Corrupt Practices Act

(FCPA) and as a general ethical issue. What duties did Kozeny have under the FCPA? [*United States v. Kozeny*, 667 F.3d 122 (2d Cir. 2011)] (See *Making Ethical Business Decisions*.)

1-5. Business Ethics. Mark Ramun worked as a manager for Allied Erecting and Dismantling Co., where he had a tense relationship with his father, who was Allied’s president. After more than ten years, Mark left Allied, taking 15,000 pages of Allied’s documents on DVDs and CDs, which constituted trade secrets. Later, he joined Genesis Equipment & Manufacturing, Inc., a competitor. Genesis soon developed a piece of equipment that incorporated elements of Allied equipment. How might business ethics have been violated in these circumstances? Discuss. [*Allied Erecting and Dismantling Co. v. Genesis Equipment & Manufacturing, Inc.*, 511 Fed.Appx. 398 (6th Cir. 2013)] (See *Business Ethics*.)

1-6. Business Ethics. Stephen Glass made himself infamous as a dishonest journalist by fabricating material for more than forty articles for *The New Republic* magazine and other publications. He also fabricated supporting materials to delude *The New Republic*’s fact checkers. At the time, he was a law student at Georgetown University. Once suspicions were aroused, Glass tried to avoid detection. Later, Glass applied for admission to the California bar. The California Supreme Court denied his application, citing “numerous instances of dishonesty and disingenuousness” during his “rehabilitation” following the exposure of his misdeeds. How do these circumstances underscore the importance of ethics? Discuss. [*In re Glass*, 58 Cal.4th 500, 316 P.3d 1199 (2014)] (See *Business Ethics*.)

1-7. Business Ethics. Operating out of an apartment in Secane, Pennsylvania, Hratch Ilanjan convinced Vicken Setrakian, the president of Kenset Corp., that he was an international businessman who could help Kenset turn around its business in the Middle East. At Ilanjan’s insistence, Setrakian provided confidential business documents. Claiming that they had an agreement, Ilanjan demanded full, immediate payment and threatened to disclose the confidential information to a Kenset supplier if payment was not forthcoming. Kenset denied that they had a contract and filed a suit in a federal district court against Ilanjan, seeking return of the documents. During discovery, Ilanjan was uncooperative. Who behaved unethically in these circumstances? Explain. [*Kenset Corp. v. Ilanjan*, 600 Fed.Appx. 827 (3rd Cir. 2015)] (See *Business Ethics*.)

1-8. Business Ethics. Priscilla Dickman worked as a medical technologist at the University of Connecticut Health Center. Dickman’s supervisor received complaints that she was getting nonbusiness-related phone calls and was absent from her work area when she should have been working. Based on e-mails and other documents found on Dickman’s work computer, the state investigated her for violations of state law. She was convicted of conducting “personal business for financial gain on state time utilizing state resources.” Separate criminal investigations resulted in convictions for

forgery and filing an unrelated fraudulent insurance claim. She “retired” from her job and filed a claim with the state of Connecticut against the health center, alleging that her former employer had initiated the investigations to harass her and force her to quit. For lack of “credible evidence or legal support,” the claim was dismissed. Which of these acts, if any, were unethical? Why? [*Dickman v. University of Connecticut Health Center*, 162 Conn.App. 441, 132 A.3d 739 (2016)] (See *Business Ethics*.)

1–9. A Question of Ethics—Consumer Rights. *Best Buy,*



a national electronics retailer, offered a credit card that allowed users to earn “reward points” that could be redeemed for discounts on Best Buy goods. After reading a newspaper advertisement for the card, Gary Davis applied for, and was given, a credit card. As part of the application process, he visited a Web page containing Frequently Asked Questions as well as terms and conditions for the card. He clicked on a button affirming that he understood the terms and conditions. When Davis received his card, it came with seven brochures about the card and the reward point program. As he read the brochures, he discovered that a \$59 annual fee would be charged for the card. Davis went back to the Web pages he had

*visited and found a statement that the card “may” have an annual fee. Davis sued, claiming that the company did not adequately disclose the fee. [Davis v. HSBC Bank Nevada, N.A., 691 F.3d 1152 (9th Cir. 2012)] (See *Business Ethics*.)*

- (a) Online applications frequently have click-on buttons or check boxes for consumers to acknowledge that they have read and understand the terms and conditions of applications or purchases. Often, the terms and conditions are so long that they cannot all be seen on one screen and users must scroll to view the entire document. Is it unethical for companies to put terms and conditions, especially terms that may cost the consumer, in an electronic document that is too long to read on one screen? Why or why not? Does this differ from having a consumer sign a hard-copy document with terms and conditions printed on it? Why or why not?
- (b) The Truth-in-Lending Act requires that credit terms be clearly and conspicuously disclosed in application materials. Assuming that the Best Buy credit-card materials had sufficient legal disclosures, discuss the ethical aspects of businesses strictly following the language of the law as opposed to following the intent of the law.

Legal Reasoning Group Activity

1–10. Global Business Ethics. Pfizer, Inc., developed a new antibiotic called Trovan (trovafloxacinmesylate). Tests showed that in animals Trovan had life-threatening side effects, including joint disease, abnormal cartilage growth, liver damage, and a degenerative bone condition. Several years later, an epidemic of bacterial meningitis swept across Nigeria. Pfizer sent three U.S. physicians to test Trovan on children who were patients in Nigeria’s Infectious Disease Hospital. Pfizer did not obtain the patients’ consent, alert them to the risks, or tell them that Médecins Sans Frontières (Doctors without Borders) was providing an effective conventional treatment at the same site. Eleven children died in the experiment, and others were left blind, deaf, paralyzed, or brain damaged. Rabi

Abdullahi and other Nigerian children filed a suit in a U.S. federal court against Pfizer, alleging a violation of a customary international law norm prohibiting involuntary medical experimentation on humans. (See *Global Business Ethics*.)

- (a) One group should use the principles of ethical reasoning discussed in this chapter to develop three arguments that Pfizer’s conduct was a violation of ethical standards.
- (b) A second group should take a pro-Pfizer position and argue that the company did not violate any ethical standards (and counter the first group).
- (c) A third group should come up with proposals for what Pfizer might have done differently to avert the consequences.



CHAPTER 2

Small Businesses and Franchises

A goal of many business students is to become an **entrepreneur**, one who initiates and assumes the financial risk of a new business enterprise and undertakes to provide or control its management. One of the first decisions an entrepreneur must make is which form of business organization will be most appropriate for the new endeavor.

In selecting an organizational form, the entrepreneur will consider a num-

ber of factors. These include (1) ease of creation, (2) the liability of the owners, (3) tax considerations, and (4) the ability to raise capital. Keep these factors in mind as you read this unit and learn about the various forms of business organization. Remember, too, in considering these business forms that the primary motive of an entrepreneur is to make profits.

Traditionally, entrepreneurs have used three major business forms—the

sole proprietorship, the partnership, and the corporation. In this chapter, we examine sole proprietorships and also look at franchises. Although the franchise is not strictly speaking a business organizational form, it is widely used today by entrepreneurs.

2-1 General Considerations for Small Businesses

Most small businesses begin as sole proprietorships. Once the business is under way, the sole proprietorship form may become too limited. The owner and any additional investors may then want to establish a more formal organization, such as a limited partnership (LP), a limited liability partnership (LLP), a limited liability company (LLC), or a corporation. These forms of business limit the owner's personal liability, or legal responsibility, for business debts and obligations. Each business form has its own advantages and disadvantages, but legal limited liability generally is necessary for those who wish to raise outside capital.

2-1a Requirements for All Business Forms

Any business, whatever its form, has to meet a variety of legal requirements, which typically relate to the following:

1. Business name registration.
2. Occupational licensing.

3. State tax registration (for instance, to obtain permits for collecting and remitting sales taxes).
4. Health and environmental permits.
5. Zoning and building codes.
6. Import/export regulations.

If the business has employees, the owner must also comply with a host of laws governing the workplace.

2-1b Protecting Intellectual Property

Protecting rights in intellectual property is a central concern for many small businesses. For instance, software companies and app developers depend on their copyrights and patents to protect their investments in the research and development required to create new programs. Without copyright or patent protection, a competitor or a customer could simply copy the software or app.

Trademarks Choosing a trademark or service mark and making sure that it is protected under trademark law can be crucial to the success of a new business venture. Indeed, a factor to consider in choosing a name for a business entity is whether the business name will be used

as a trademark. The general rule is that a trademark cannot be the same as another's mark or so similar that confusion might result.

For the most protection, trademarks should be registered with the U.S. Patent and Trademark Office (PTO). If the mark is federally registered, the owner may use the symbol ® with the mark. This well-known symbol puts others on notice of the registration and helps to prevent trademark infringement. An owner who has not registered can use the symbol ™. Registration with the PTO should be renewed five years after the initial registration and at ten-year intervals thereafter.

Trade Secrets Much of the value of a small business may lie in its trade secrets, such as information about product development, production processes and techniques, and customer lists. Preserving the secrecy of the information is necessary for legal protection.

As a practical matter, trade secrets must be divulged to key employees. Thus, any business runs the risk that those employees might disclose the secrets to competitors—or even set up competing businesses themselves.

To protect their trade secrets, companies may require employees who have access to trade secrets to agree in their employment contracts never to divulge those secrets. A small business may also choose to include a covenant not to compete in an employment contract. A noncompete clause will help to protect against the possibility that a key employee will go to work for a competitor or set up a competing business.

2-1c Obtaining Loans

Raising capital is critical to the growth of most small businesses. In the early days of a business, the sole proprietor may be able to contribute sufficient capital, but as the business becomes successful, more funds may be needed. The owner may want to raise capital from external sources to expand the business. One way to do this is to borrow funds.

Obtaining a bank loan is beneficial for small businesses because it allows the owner to retain full ownership and control of the business. Note, though, that the bank may place some restrictions on future business decisions as a condition of granting the loan. In addition, bank loans may not be available for some businesses. Banks are usually reluctant to lend significant sums to businesses that are not yet established. Even if a bank is willing to make

such a loan, the bank may require personal guaranty contracts from the owner, putting the owner's personal assets at risk.

Loans with desirable terms may be available from the U.S. Small Business Administration (SBA). One SBA program provides loans of up to \$25,000 to businesspersons who are women, low-income individuals, or members of minority groups. Be aware that the SBA requires business owners to put some of their own funds at risk in the business. In addition, many states offer small-business grants to individuals starting a business.

2-2 Sole Proprietorships

In the earliest stages, as mentioned, a small business may operate as a **sole proprietorship**, which is the simplest form of business. In this form, the owner is the business. Thus, anyone who does business without creating a separate business organization has a sole proprietorship. The law considers all new, single-owner businesses to be sole proprietorships unless the owner affirmatively adopts some other form.

More than two-thirds of all U.S. businesses are sole proprietorships. Sole proprietors can own and manage any type of business from an informal, home-office or Web-based undertaking to a large restaurant or construction firm. About 99 percent of the sole proprietorships in the United States have revenues of less than \$1 million per year.

2-2a Advantages of the Sole Proprietorship

A major advantage of the sole proprietorship is that the proprietor owns the entire business and receives all of the profits (because she or he assumes all of the risk). In addition, starting a sole proprietorship is easier and less costly than starting any other kind of business because few legal formalities are required. Generally, no documents need to be filed with the government to start a sole proprietorship.¹

1. Although starting a sole proprietorship involves fewer legal formalities than other business organizational forms, even a small sole proprietorship may need to comply with zoning requirements, obtain a state business license, and the like.

Taxes A sole proprietor pays only personal income taxes (including Social Security and Medicare taxes) on the business's profits. The profits are reported as personal income on the proprietor's personal income tax return. In other words, the business itself need not file an income tax return. Sole proprietors are allowed to establish retirement accounts that are tax-exempt until the funds are withdrawn.

Like any form of business enterprise, a sole proprietorship can be liable for other taxes, such as those collected and applied to the disbursement of unemployment compensation. Whether liability for the unpaid unemployment compensation taxes of a sole proprietorship remains with the seller or must be assumed by the buyer was at issue in the following case.

Case Analysis 2.1

A. Gadley Enterprises, Inc. v. Department of Labor and Industry Office of Unemployment Compensation Tax Services

Commonwealth Court of Pennsylvania, __ A.3d __, 2016 WL 55591 (2016).

In the Language of the Court

SIMPSON, Judge.

[Julianne Gresh (Predecessor)] operated [Romper Room Day Care (Romper Room)], a childcare center, as a sole proprietorship for 12 years. Predecessor owed the [Pennsylvania Department of Labor and Industry Office of Unemployment Compensation Tax Services (Department)] substantial unpaid UC [unemployment compensation] contributions, interest and penalties. She admitted liability and entered payment plans with the Department *** Pursuant to these payment plans, she made monthly payments in the minimal amount of \$50. Predecessor was on the verge of losing her license to operate, and sought another entity to operate the location as a childcare facility.

[A. Gadley Enterprises, Inc. (Purchaser)] operated a childcare center, Young Environment Learning Center, in Erie, Pennsylvania. Purchaser decided to purchase assets from Predecessor in order to open a satellite location of Young Environmental Learning Center at the prior location of Romper Room. Purchaser and Predecessor executed an asset purchase agreement (Agreement).

Through the Agreement, Purchaser paid a total of \$37,000 for Predecessor's tangible and intangible assets. This total was comprised of \$10,000 for the use of the name "Romper Room," \$10,790 for a covenant not to compete, and \$17,210 for tangible assets listed on [an attached] Inventory List.

*** The Inventory List did not include any of Predecessor's personal

assets other than those used in the operation of Romper Room.

*** Four days after executing the Agreement, *** Predecessor notified the Department of the sale.

*** The Department issued Purchaser a Notice of Assessment (Notice) in the amount of \$43,370.49 for UC contributions, interest and penalties owed by Predecessor. The Notice stated Purchaser was liable because it purchased 51% or more of Predecessor's assets.

In response, Purchaser filed a petition [with the Department] for reassessment.

Based on the evidence presented at the hearing [held on the petition], the Department issued its decision and order denying the petition for reassessment.

Purchaser then filed a petition to review to this Court.

[43 Pennsylvania Statutes Section 788.3(a), part of the state's Unemployment Compensation Law] provides:

(a) Every employer *** , who shall sell in bulk fifty-one percent or more of his assets, including but not limited to, any stock of goods, wares or merchandise of any kind, fixtures, machinery, equipment, building or real estate, shall give the department ten (10) days' notice of the sale prior to completion of the transfer *** .

The employer shall present to the purchaser of such property, a certificate *** showing that all reports have been filed and contributions, interest and penalties paid to the date of the proposed transfer. The failure of the

purchaser to require such certificate shall render such purchaser liable to the department for the unpaid contributions, interest and penalties.

There is no dispute that Purchaser did not obtain a clearance certificate reflecting Predecessor's payment of UC liability. There is also no dispute that Predecessor owed the Department for outstanding UC contributions, interest and penalties in the amount of \$43,370.49 at the time of the sale.

Purchaser argues substantial evidence does not support the Department's finding that it purchased more than 51% of the [Predecessor's] assets.

The Agreement establishes that the Inventory List sets forth all business assets of Predecessor. Gresh confirmed the Inventory List was a complete list of assets used in the operation of her business.

The Inventory List reflects a total value of assets equaling \$19,210. *** The parties reduced the purchase price by \$2,000 to account for the reduced value of the assets when Purchaser removed certain assets from the complete Inventory List. Purchaser acquired all the assets included in the Inventory List, other than those removed, for \$17,210. The amount constitutes approximately 90% of the value of the complete list of assets ($\$19,210 \times .9 = \$17,289$).

The Agreement, supplemented by corroborating [supporting] testimony,



Case 2.1 Continued

constitutes substantial evidence to support the Department's finding that the sale qualified as a bulk sale of more than 51% of Predecessor's assets.

Purchaser also argues the Department erred in construing the term "assets" in the bulk sales provision to include only business assets when determining whether a sale met the 51% threshold. Purchaser asserts the provision does not differentiate between business and personal assets of an employer and there is no legal distinction when the employer is a sole proprietor.

***The definition of "employer" [in the UC Law] includes a sole proprietor like Predecessor.

The word "assets" is not defined in the [UC] Law.

[In Section 788.3(a)] the term "assets" precedes a list of examples, followed by the phrase "including but not limited to."

***The examples *** indicate that the term "assets" refers to business

assets. This conclusion is buttressed [reinforced] by the context of the statute as a whole, which pertains to employers operating businesses and paying employees as part of their business operations.

The factual circumstances surrounding the sale also indicate the term "assets" means "business assets." Here, the context is the sale of a business, in the childcare industry, to another business engaged in the same industry that intends to operate a childcare facility at the location of the former business. The Agreement reflects the intention of the parties that Purchaser would operate the childcare facility as a satellite location. [Emphasis added.]

***The provision does not treat sole proprietors differently than other employers. The provision contains no exemption of liability for a purchaser when an employer operates as a sole proprietorship. Nor does it contain an exemption from liability when the former employer entered a repayment plan with the Department.

Moreover, Purchaser's interpretation does not consider *the purpose of the bulk*

sales provision. That purpose is to ensure an employer does not divest itself of assets without satisfying outstanding liabilities, either itself or by the purchaser. This Court agrees with the Department that Gresh's repayment agreement in the minimal amount of \$50 per month does not satisfy the UC liability. [Emphasis added.]

In sum, the Department's construction of assets as business assets is reasonable and consistent with the context and purpose of [the] bulk sales provision. Purchaser's failure to obtain a clearance certificate rendered it liable for Predecessor's unpaid UC contributions, interest and penalties, regardless of Predecessor's repayment agreement. Therefore, this Court upholds the Department's interpretation of the bulk sales provision.

*** For the foregoing reasons, we affirm the Department.

Legal Reasoning Questions

1. As is clear from the law applied in this case, and the result, the liability of a business for unpaid taxes "follows the assets." Why?
2. What action can Gadley take now to avoid suffering the loss of the funds required to cover Gresh's unpaid taxes?
3. What action should a buyer take *before* purchasing the assets of a business to avoid liability for the seller's unpaid taxes?

Flexibility A sole proprietorship offers more flexibility than does a partnership or a corporation. The sole proprietor is free to make any decision she or he wishes concerning the business—including what kind of business to pursue, whom to hire, and when to take a vacation. The sole proprietor can sell or transfer all or part of the business to another party at any time without seeking approval from anyone else. In contrast, approval is typically required from partners in a partnership and from shareholders in a corporation.

2-2b Disadvantages of the Sole Proprietorship

The major disadvantage of the sole proprietorship is that the proprietor alone bears the burden of any losses

or liabilities incurred by the business enterprise. In other words, the sole proprietor has unlimited liability for all obligations that arise in doing business. Any lawsuit against the business or its employees can lead to unlimited personal liability for the owner of a sole proprietorship.

■ **EXAMPLE 2.1** Aaron and Melissa Klein, owners of the Sweet Cakes by Melissa bakery, refused to bake a wedding cake for a same-sex couple's wedding. They claimed that their religious beliefs did not allow them to provide services for same-sex ceremonies. The Oregon State Bureau of Labor and Industries argued that their decision violated the law. In 2015, an administrative law judge ruled against the Kleins' motion to dismiss and ordered them to pay \$135,000 in damages. As sole proprietors, the Kleins were personally responsible for paying the damages. ■

Personal Assets at Risk Creditors can pursue the owner's personal assets to satisfy any business debts. Although sole proprietors may obtain insurance to protect the business, liability can easily exceed policy limits. This unlimited liability is a major factor to be considered in choosing a business form.

■ **EXAMPLE 2.2** Sheila Fowler operates a golf shop near a world-class golf course as a sole proprietorship. One of Fowler's employees fails to secure a display of golf clubs. They fall on Dean Maheesh, a professional golfer, and seriously injure him. If Maheesh sues Fowler's shop and wins, Fowler's personal liability could easily exceed the limits of her insurance policy. Fowler could lose not only her business, but also her house, car, and any other personal assets that can be attached to pay the judgment. ■

Lack of Continuity and Limited Ability to Raise Capital The sole proprietorship also has the disadvantage of lacking continuity after the death of the proprietor. When the owner dies, so does the business—it is automatically dissolved.

Another disadvantage is that in raising capital, the proprietor is limited to his or her personal funds and any loans that he or she can obtain for the business. Lenders may be unwilling to make loans to sole proprietorships, particularly start-ups, because the sole proprietor risks unlimited personal liability and may not be able to pay. (See this chapter's *Digital Update* feature for a discussion of one court's refusal to discharge a loan made to a sole proprietor who had declared bankruptcy.)

DIGITAL UPDATE

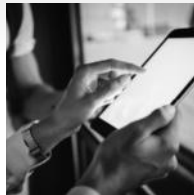
A Sole Proprietorship, Facebook Poker, and Bankruptcy

One major downside of a sole proprietorship is that it is more difficult for a sole proprietor to obtain funding for start-up and expansion. Moreover, if funding is obtained through loans, the sole proprietor is exposed to personal liability.

Personal Liability Exposure for an Online Startup

A case in point went before the United States bankruptcy court in Massachusetts in 2015.^a Michael Dewhurst, living in Raynham, Massachusetts, sometimes did computer work for Gerald Knappik. Dewhurst decided to start a new business venture—the commercial development of a Facebook poker-playing application. Dewhurst envisioned an application that would enable multiple individuals to play poker together over the Internet through Facebook. Dewhurst informed Knappik of his business plan and predicted that his Facebook poker application “was going to be something very big.”

Knappik initially loaned \$50,000 to Dewhurst for the project. The loan agreement stated, “The sole purpose of this loan agreement is to provide funds on a personal level for the startup of said business project, in conjunction with borrower's personal funds, not limited to startup costs, operating expenses, advertising costs.”



That was the first of a series of personal loans that totaled \$220,000.

Dewhurst had repaid only \$9,000 on the total outstanding debt when he filed for bankruptcy. Ultimately, the bankruptcy court ascertained that at least \$120,000 of the loans that were supposed to be used exclusively for the Facebook poker project had been used for other activities. Furthermore, Dewhurst kept “no contemporaneous records of his disbursements and uses of this cash, no cash journal, ledger, or disbursement slips of any kind.”

The Lender Objects to a Bankruptcy Discharge of Monies Owed

During bankruptcy proceedings, Knappik requested that the bankruptcy court deny discharge of Dewhurst's debts to him. Upon review, the court stated that “Dewhurst's failure to keep and preserve adequate records makes it impossible to reconstruct an accurate and complete account of financial affairs and business transactions.” The bankruptcy judge ultimately denied discharge of \$120,000 of the debt owed to Knappik. Thus, a sole proprietor's failed attempt to create an online poker-playing application led to personal liability even after he had filed for bankruptcy.

Critical Thinking *Sole proprietorships, as well as other businesses, routinely seek funding for online projects. How can the individuals involved avoid personal liability?*

a. *In re Dewhurst*, 528 Bankr. 211 (D.Mass. 2015).

2-3 Franchises

Instead of setting up a sole proprietorship to market their own products or services, many entrepreneurs opt to purchase a franchise. A **franchise** is an arrangement in which the owner of intellectual property—such as a trademark, a trade name, or a copyright—licenses others to use it in the selling of goods or services. A **franchisee** (a purchaser of a franchise) is generally legally independent of the **franchisor** (the seller of the franchise). At the same time, the franchisee is economically dependent on the franchisor's integrated business system. In other words, a franchisee can operate as an independent businessperson but still obtain the advantages of a regional or national organization.

Today, franchising companies and their franchisees account for a significant portion of all retail sales in this country. Well-known franchises include McDonald's, 7-Eleven, and Holiday Inn. Franchising has also become a popular way for businesses to expand their operations internationally without violating the legal restrictions that many nations impose on foreign ownership of businesses.

2-3a Types of Franchises

Many different kinds of businesses sell franchises, and numerous types of franchises are available. Generally, though, franchises fall into one of three classifications: distributorships, chain-style business operations, and manufacturing arrangements.

Distributorship In a *distributorship*, a manufacturer (the franchisor) licenses a dealer (the franchisee) to sell its product. Often, a distributorship covers an exclusive territory. Automobile dealerships and beer distributorships are common examples.

■ **EXAMPLE 2.3** Black Bear Beer Company distributes its brands of beer through a network of authorized wholesale distributors, each with an assigned territory. Marik signs a distributorship contract for the area from Gainesville to Ocala, Florida. If the contract states that Marik is the exclusive distributor in that area, then no other franchisee may distribute Black Bear beer in that region. ■

Chain-Style Business Operation In a *chain-style business operation*, a franchise operates under a franchisor's trade name and is identified as a member of a select group of dealers that engage in the franchisor's business. The franchisee is generally required to follow standardized or prescribed methods of operation. Often, the franchisor

insists that the franchisee maintain certain standards of performance.

In addition, the franchisee may be required to obtain materials and supplies exclusively from the franchisor. Chipotle Mexican Grill and most other fast-food chains are examples of this type of franchise. Chain-style franchises are also common in service-related businesses, including real estate brokerage firms, such as Century 21, and tax-preparing services, such as H&R Block, Inc.

Manufacturing Arrangement In a *manufacturing, or processing-plant, arrangement*, the franchisor transmits to the franchisee the essential ingredients or formula to make a particular product. The franchisee then markets the product either at wholesale or at retail in accordance with the franchisor's standards. Examples of this type of franchise include Pepsi-Cola and other soft-drink bottling companies.

2-3b Laws Governing Franchising

Because a franchise relationship is primarily a contractual relationship, it is governed by contract law. If the franchise exists primarily for the sale of products manufactured by the franchisor, the law governing sales contracts as expressed in Article 2 of the Uniform Commercial Code applies.

Additionally, the federal government and most states have enacted laws governing certain aspects of franchising. Generally, these laws are designed to protect prospective franchisees from dishonest franchisors and to prevent franchisors from terminating franchises without good cause.

Federal Regulation of Franchises The federal government regulates franchising through laws that apply to specific industries and through the Franchise Rule, created by the Federal Trade Commission (FTC).

Industry-Specific Standards. Congress has enacted laws that protect franchisees in certain industries, such as automobile dealerships and service stations. These laws protect the franchisee from unreasonable demands and bad faith terminations of the franchise by the franchisor.

An automobile manufacturer–franchisor cannot make unreasonable demands of dealer–franchisees or set unrealistically high sales quotas. If an automobile manufacturer–franchisor terminates a franchise because of a dealer–franchisee's failure to comply with unreasonable demands, the manufacturer may be liable for damages.²

2. Automobile Dealers' Franchise Act, also known as the Automobile Dealers' Day in Court Act, 15 U.S.C. Sections 1221 *et seq.*

Similarly, federal law prescribes the conditions under which a franchisor of service stations can terminate the franchise.³ In addition, federal antitrust laws sometimes apply in specified circumstances to prohibit certain types of anticompetitive agreements.

The Franchise Rule. The FTC’s Franchise Rule requires franchisors to disclose certain material facts that a prospective franchisee needs in order to make an informed decision concerning the purchase of a franchise.⁴ Those who violate the Franchise Rule are subject to substantial civil penalties, and the FTC can sue on behalf of injured parties to recover damages.

The rule requires the franchisor to make numerous written disclosures to prospective franchisees (see Exhibit 2–1). All representations made to a prospective franchisee must have a reasonable basis. For instance, if a franchisor provides projected earnings figures, the franchisor must indicate whether the figures are based on actual data or hypothetical examples. If a franchisor makes sales or earnings projections based on actual data for a specific

franchise location, the franchisor must disclose the number and percentage of its existing franchises that have achieved this result.

State Regulation of Franchising State legislation varies but often is aimed at protecting franchisees from unfair practices and bad faith terminations by franchisors.

State Disclosures. A number of states have laws similar to the federal rules that require franchisors to provide presale disclosures to prospective franchisees.⁵ Many state laws also require that a disclosure document (known as the Franchise Disclosure Document, or FDD) be registered or filed with a state official. State laws may also require that a franchisor submit advertising aimed at prospective franchisees to the state for approval.

To protect franchisees, a state law might require the disclosure of information such as the actual costs of operation, recurring expenses, and profits earned, along with facts substantiating these figures. State deceptive trade

3. Petroleum Marketing Practices Act (PMPA), 15 U.S.C. Sections 2801 *et seq.*

4. 16 C.F.R. Section 436.1.

5. These states include California, Florida, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Texas, Utah, Virginia, Washington, and Wisconsin.

EXHIBIT 2–1 The FTC’s Franchise Rule Requirements

REQUIREMENT	EXPLANATION
Written (or Electronic) Disclosures	The franchisor must make numerous disclosures, such as the range of goods and services included and the value and estimated profitability of the franchise. Disclosures can be delivered on paper or electronically. Prospective franchisees must be able to download or save any electronic disclosure documents.
Reasonable Basis for Any Representations	To prevent deception, all representations made to a prospective franchisee must have a reasonable basis at the time they are made.
Projected Earnings Figures	If a franchisor provides projected earnings figures, the franchisor must indicate whether the figures are based on actual data or hypothetical examples. The Franchise Rule does not require franchisors to provide potential earnings figures, however.
Actual Data	If a franchisor makes sales or earnings projections based on actual data for a specific franchise location, the franchisor must disclose the number and percentage of its existing franchises that have achieved this result.
Explanation of Terms	Franchisors are required to explain termination, cancellation, and renewal provisions of the franchise contract to potential franchisees before the agreement is signed.

practices acts may also apply and prohibit certain types of actions by franchisors.

May Require Good Cause to Terminate the Franchise.

To prevent arbitrary or bad faith terminations, a state law may prohibit termination without “good cause” or require that certain procedures be followed in terminating a franchise. ■ **CASE IN POINT 2.4** FMS, Inc., entered into a franchise agreement with Samsung Construction Equipment North America to become an authorized dealership selling Samsung construction equipment. Samsung then sold its equipment business to Volvo Construction Equipment North America, Inc., which was to continue selling Samsung brand equipment.

Later, Volvo rebranded the construction equipment under its own name and canceled FMS’s franchise. FMS sued, claiming that Volvo had terminated the franchise without “good cause” in violation of state law. Because Volvo was no longer manufacturing the Samsung brand equipment, the court found that Volvo had good cause to terminate FMS’s franchise. If Volvo had continued making the Samsung equipment, though, it could not have terminated the franchise.⁶ ■

2-3c The Franchise Contract

The franchise relationship is defined by the contract between the franchisor and the franchisee. The franchise contract specifies the terms and conditions of the franchise and spells out the rights and duties of the franchisor and the franchisee. If either party fails to perform its contractual duties, that party may be subject to a lawsuit for breach of contract. Furthermore, if a franchisee is induced to enter into a franchise contract by the franchisor’s fraudulent misrepresentation, the franchisor may be liable for damages. Generally, statutes and the case law governing franchising tend to emphasize the importance of good faith and fair dealing in franchise relationships.

Because each type of franchise relationship has its own characteristics, franchise contracts tend to differ. Nonetheless, certain major issues typically are addressed in a franchise contract. We look at some of them next.

Payment for the Franchise The franchisee ordinarily pays an initial fee or lump-sum price for the franchise license (the privilege of being granted a franchise). This fee is separate from the various products that the franchisee purchases from or through the franchisor. The franchise agreement may also require the franchisee to pay a

percentage of the franchisor’s advertising costs and certain administrative expenses.

In some industries, the franchisor relies heavily on the initial sale of the franchise for realizing a profit. In other industries, the continued dealing between the parties brings profit to both. Generally, the franchisor receives a stated percentage of the annual (or monthly) sales or volume of business done by the franchisee.

Business Premises The franchise agreement may specify whether the premises for the business must be leased or purchased outright. Sometimes, a building must be constructed to meet the terms of the agreement. The agreement will specify whether the franchisor or the franchisee is responsible for supplying equipment and furnishings for the premises.

Location of the Franchise Typically, the franchisor determines the territory to be served. Some franchise contracts give the franchisee exclusive rights, or “territorial rights,” to a certain geographic area. Other franchise contracts, while defining the territory allotted to a particular franchise, either specifically state that the franchise is nonexclusive or are silent on the issue of territorial rights.

Many franchise disputes arise over territorial rights, and the implied covenant of good faith and fair dealing often comes into play in this area of franchising. If the contract does not grant exclusive territorial rights to the franchisee and the franchisor allows a competing franchise to be established nearby, the franchisee may suffer significant lost profits. In this situation, a court may hold that the franchisor breached an implied covenant of good faith and fair dealing.

Business Organization The franchisor may require that the business use a particular organizational form and capital structure. The franchise agreement may also set out standards such as sales quotas and record-keeping requirements. Additionally, a franchisor may retain stringent control over the training of personnel involved in the operation and over administrative aspects of the business.

Quality Control by the Franchisor The day-to-day operation of the franchise business normally is left up to the franchisee. Nonetheless, the franchise agreement may specify that the franchisor will provide some degree of supervision and control so that it can protect the franchise’s name and reputation.

Means of Control. When the franchise prepares a product, such as food, or provides a service, such as motel

6. *FMS, Inc. v. Volvo Construction Equipment North America, Inc.*, 557 F.3d 758 (7th Cir. 2009).