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## Introduction: The Legal and Ethical Environment of Business

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## **The Legal and Ethical Environment of Business**

v2.0 Terence Lau and Lisa Johnson

### CHAPTER 1

# Introduction to Law

## Learning Objectives

After reading this chapter, you should be able to understand the nature and sources of law, and the concept of the rule of law and how it affects business and economic prosperity. At the conclusion of this chapter, you should be able to answer the following questions:

1. What is the law?
2. Where does our law come from?
3. What is a rule of law?
4. How is the law relevant to business?
5. How does the study of the legal environment of business create a foundation for future business courses?

You might be wondering what the law has to do with you. You try to follow the rules. You don't get into any trouble. You want to engage in honest dealings in business. Besides, you can always hire an attorney if you need legal help.

This may all be true. However, it is imperative for those in the business world to understand the legal environment in which they are operating. The legal environment in which businesses operate dictates virtually every aspect of a business's operations, from the time the business is created to the way laws regulate its activity to the way it treats its workers, and everything in between. For example, while you may have the best intentions and be truly diligent in your efforts to do business fairly, inevitably conflicts will

arise in everyday business dealings. The legal environment provides a framework to resolve those conflicts, called litigation. We'll explore litigation, and alternatives to this expensive process, later in this book. Sometimes, though, having a legal answer to a problem isn't satisfactory. Consider, for example, what does it mean to do business "fairly"? Fair to whom? Fair to your shareholders? Fair to your employees? Fair to the consumers who will purchase your products? Through which ethical lens will you contemplate these issues? Trade-offs are a part of business. If you want to increase shareholder profits, for example, you may need to reduce labor costs by using cheaper labor. If you pay your employees less, your employees will be less well-off, but your shareholders may be happier. In business you'll find that often, just being legal isn't enough to satisfy your notions of fairness. For that reason, it's important to consider not just what the law says, but why the law exists (this is known as public policy).

A good example of how public policy and the law aren't always on the same page can be seen in the credit crisis that came to the world's attention in October 2008 and nearly toppled the U.S. economy into depression. Hundreds of thousands of homes were foreclosed by banks (Figure 1.1), leading to a vicious cycle of depressed housing prices, shattered consumer confidence, and business retrenchment. You may be thinking that this has little to do with you or with the study of the legal environment of business. Think again. The legal environment that banks operated in allowed the credit crisis to occur, and the end result was pain for millions of people.

In a nutshell, the U.S. financial system nearly collapsed under the weight of high default rates among mortgagees, the issuance of excessive subprime mortgages to unqualified debtors, collateralized debt obligations (CDOs) that were not being serviced and could not be sold, and a mortgage banking system with flawed incentive structures from the bottom to the top. The mortgage industry created incentives for those who worked in that industry to act in their own self-interest to make a profit, even at the expense of the long-term health of the institutions for which they were working.

Considering this flawed incentive system, the results were not surprising to many economists, who know that people tend to act in their own self-interest, even at the expense of their institutions' goals. Mortgage brokers had very strong incentives to approve every mortgage applicant, regardless of creditworthiness or ability to service the mortgage. This was because the lenders were pressuring them for more mortgages, so that the lenders themselves could sell those mortgages for a profit. And this pressure for "more" was endemic at every level of the mortgage industry, from the would-be homeowner who wanted more house than he or she could afford to the investment

**Figure 1.1 The Credit Crisis**



Source: Photo courtesy of Brendel, <http://en.wikipedia.org/wiki/File:Foreclosedhome.JPG>.

bankers who wanted more CDOs on which they could profit. This desire for more mortgages led to excessive risk being undertaken, and when mortgagees began defaulting on their mortgages, the market became flooded with houses that had been foreclosed. As supply of houses increased and demand for them fell, housing prices plummeted, which meant that not only were the investors not receiving income on their investments, but homeowners were losing the value of their investments, since their house values were plummeting. The end result was that many homeowners were “upside down” on their obligations, meaning that they owed more on their houses than what the houses were worth. This created an incentive for mortgagees to abandon their debt obligations. When the investors did not receive income on their investments, they also were not receiving the cash flow to cover their debts, and they could not service their obligations under their CDOs. Parties at every level began clamoring for protection from their creditors from the U.S. bankruptcy courts by filing petitions for bankruptcy.

## Hyperlink: Credit Crisis

<http://vimeo.com/3261363>

This video explains the credit crisis and will help you begin thinking about the intersection between the legal environment of business and the role of government in regulating business.

After watching the video in “[Hyperlink: Credit Crisis](#)”, consider the intersection between law and economics. Former Federal Reserve Chairman Alan Greenspan had consistently maintained that private regulation (that is, self-regulation by private industry) was better at containing risk than government regulation. But when the 2008 credit crisis manifested, Greenspan retracted this belief, at least in part. He expressed that he was in “a state of shocked disbelief” concerning the financial institutions’ inability to self-regulate.<sup>[1]</sup> He always believed that the incentive of survival of the institution itself would force banks to self-regulate. However, this “shocked disbelief” underscored a fissure within the discipline of economics—namely, whether the same economic principles that apply to individuals also apply to organizations. While we know from our study of economics that individuals act in their own self-interest, the 2008 credit crisis perhaps illustrated that people continue to act in their own self-interest, even when working within a firm. The firm itself is only a collection of individual people, and so the firm itself does not act in any type of organizational self-interest. It’s no surprise, then, that by the time the credit crisis was over Greenspan and others threw their support behind comprehensive banking reforms and regulations that became the Dodd-Frank Wall Street Reform and Consumer Protection Act and the creation of a Consumer Financial Protection Bureau.

You might be wondering why we are discussing economics. This is because economic principles are intertwined with economic prosperity, and economic prosperity is intertwined with business, as the preceding example illustrates. To understand what happened in the credit crisis and, more importantly,

how to prevent something like this from happening in the future, we have to understand economic principles that impel behavior. Additionally, we can use our understanding of economics to create laws to prevent situations like this from happening in the future. Specifically, while a basic principle of economics is that individuals act in their own self-interest, they do so within the rules of the game. That is, they do so within the parameters of the law. Additionally, sometimes individuals weigh the penalties of violating the law against the chances of getting caught to determine how they should behave. In both instances, the law is a restraint on behavior. Ignoring what we know about economics when creating laws may be the same as inviting future crises.

Reflect on the credit crisis and how our laws could have entirely averted or seriously mitigated the fallout that resulted from it. For example, if the laws regulated the incentive structures that exist within private industry, the individual incentive to make a profit would not have been allowed to overtake the financial institutions' need to self-preserve by limiting risk. Likewise, if our banking regulations limited the types of services that banks could offer, perhaps the exotic financial instruments that were created as a precursor to the credit crisis would not have been permitted in the first place. If the size of our financial institutions had been limited by law, the dangerous fallacy that the financial institutions were too large to fail could not have been perpetuated. If compensation packages were legally restricted by limitations on size or severed from linkages to performance, then individual incentives to maximize profit could have been restrained. Additionally, this situation raises several ethics questions. For example, was it ethical to loan money to people who were not able to service those debts?

The study of law can help analyze the extent to which our legal system permits the regulation of things like types of services that banks can offer, size of financial institutions, compensation packages, or incentive structures. Additionally, learning about law can help you recognize under what authority our legal system allows or prevents such regulations. In other words, the study of law allows us to understand both the reach and the limits of our legal system.

As you think about these questions and the many other questions that will arise during your study of the legal environment of business, try to set aside any fixed ideas that you have already formulated about law and the legal system. Many students who are new to the study of law find themselves sharply swayed by a particular type of fiction that has grown around the legal system. Specifically, many students find that they harbor a sense of repugnance to law, because they have heard that it is filled with frivolous lawsuits brought by a litigious public waiting to pounce at the smallest slight, along with money-grubbing attorneys waiting to cash in. We ask that you set aside those and any other preconceived notions that you may harbor about the law and the legal system. The law is a dynamic, sophisticated field. Frivolous lawsuits are not permitted to advance in our legal system, and most attorneys are committed to justice and fairness. They work hard to protect their clients' legal interests and simply do not have the desire or the time to pursue frivolous claims. Indeed, there is no incentive for them to pursue such claims, because our legal system does not reward such behavior. Often people form their opinions about the law and the legal system from

various mass media sources. However, keep in mind that our media outlets are in the business to make money. Often, they will focus on a particular fact of a case and sensationalize it, rather than diligently relaying all known facts and the legal questions presented by those facts. Why? Because the first approach sells, but the latter approach is generally too technical to hold the interest of large numbers of people. So, if you have learned about the legal system from “the news,” or from surfing the Internet, then remember that you have only glimpsed a small, often distorted, piece of the puzzle.

Most people want to conduct themselves and their business dealings within the parameters of the law. Even if we are very cynical, barring any other compunction to behave well, we can see that it makes the most economic sense to do so. Following the rules of the game saves us money, time, and aggravation, and it preserves our individual and professional reputations. So if most people recognize that they have an incentive not to run afoul of the law, why are there so many legal disputes? There are many reasons for this, such as the fact that many of our laws are ambiguous, and reasonable people may disagree about what is “right.” Additionally, legal injuries happen even under the best of conditions, and the aggrieved parties need a method to press their claims to be compensated for their damages.

A common theme in the study of the legal environment is responsibility. Much of our legal wrangling seeks to answer the questions, “Who is responsible, and what should be done about this injury?” Additionally, and perhaps more importantly for business, is the concern of how to limit liability exposure in the first place. A solid understanding of the legal environment of business should help limit the risk of liability and thus avoid legal disputes. Moreover, it should help you recognize when you need to contact your attorney for assistance in defining the contours of the law, which are the rules of the game. The law provides continuity and a reasonable expectation of how things will be, based on how they have been in the past. It provides predictability and stability.

This book does not teach you how to practice law or to conduct legal research. That is the work of attorneys. Legal research is a sophisticated method of research that seeks to determine the current state of the law regarding narrowly defined legal issues. Legal research helps guide our behavior to help us comply with the rules of the game. When you need an answer regarding a specific legal issue, you will contact your attorney, who will research the issue, inform you of the results of that research, and advise you of the decisions you must make with respect to that issue.

The goals of this book are practical. Try to conceptualize your study of the legal environment of business as a map by which you must navigate your business dealings. We want to teach you how to read this map so that you are able to understand the law and how it affects your business and your life. An understanding of the law can help you to avoid serious missteps, which can limit your legal liability proactively. This is far better than being in constant reactionary mode. That is, planning can avoid or minimize liability exposure. Simply reacting to legal issues after they have arisen can be costly. As you have probably heard, ignorance of the law is no defense for violating the law.

This chapter provides an overview of the legal system. We begin with a discussion of what the law is, and we turn our attention to the sources of law, the rule of law, the reasons why rule of law is important to business, and how law affects business disciplines such as management, marketing, finance, and accounting. The chapter concludes with a discussion of the link between rule of law and economic prosperity.

## Key Takeaway

Law is a dynamic and ever-changing field that affects everyone, both in their individual capacities as people and in their business interactions. Studying the legal environment of business helps us understand how to reduce liability risks, identify legal problems that require an attorney's assistance, and identify the links between business and the law.

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## Footnotes

1. Brian Knowlton and Michael M. Grynbaum, "Greenspan 'Shocked' That Free Markets Are Flawed," New York Times, October 23, 2008, <http://www.nytimes.com/2008/10/23/business/worldbusiness/23iht-gspan.4.17206624.html> (accessed August 18, 2010). ↑