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**STRATEGY**

**AN EXAMINATION OF THE ACCURACY OF  
SMALL MANUFACTURER CHIEF EXECUTIVE OFFICERS  
IN ASSESSING THE LEGALITY OF SELECTED ACTIONS**

**Robin T. Peterson**  
New Mexico State University  
Ropeters@nmsu.edu

**ABSTRACT**

*This inquiry investigated the degree of familiarity of C.E.O.s of small manufacturing firms with federal regulations. Important findings were that the managers, especially those employed by firms producing industrial goods, were deficient in their familiarity with the terms of government regulations and could benefit from the acquisition of further insights. Implications and suggestions for the C.E.O.s. are provided.*

**INTRODUCTION**

Top managers of small manufacturing firms should be cognizant of the major federal laws which impact them. Research suggests that they perceive their organizations as less law abiding than do lower-level managers (Petrick, Scherer, Wendt, & Cox, 1994). However, it is possible that some C.E.O.s mistakenly perceive the depth of their knowledge of this subject and incorrectly assume that they can assess which actions are congruent with the law and which are not. If this condition exists, these managers are placing themselves in a position of exposure to potential prosecution with all of the associated ramifications (Debble, 2001). Given these circumstances, top managers of small manufacturing companies may benefit through becoming aware of the level of their legal knowledge of federal laws.

Small manufacturers face a formidable and continually shifting body of federal law which influences their actions. The laws exert an effect on a wide range of company activities (Hamel, 2003; Posner, 1997).

There are constraints on hiring, promoting employees, supervisory practices, safety, raising capital, accounting methods, financial reporting, advertising, pricing, dealing with suppliers, dealing with competitors, and numerous other activities (Black, 2003; Stanley, 2003; Peritz, 2002; Ballam, 2000; Moorhouse, Morris, & Whipples, 1999).

Modifications in the laws and the manner in which they are interpreted over time can insert ambiguity in the perceptions of small manufacturing company C.E.O.s. These changes can be very difficult to predict (Stock, 2003). Those who do research in this area often discover that their predictions must be continually updated (Audretsch, Baumol, & Burke, 2001). Experience indicates that shifts in the regulations may necessitate continual surveillance of the federal level legal processes. Some fields that have witnessed recent modifications in the regulations include restrictions on price offers and promotions (Sinha, Chandra, & Srinivasan, 1999), bribes in international transactions (McCubbins, 2001), wage and hour regulations (Thompson, 2003), overtime regulations (Nicolai, 2003),

deception of consumers (Waterson, 2003), and communications among competitors (Gilliland & Manning, 2002).

Executives who are employed by small manufacturers must contend with a formidable burden imposed by legal matters. Regional and local managers who have positions with larger enterprises are not directly responsible for many of the actions that the federal government monitors. Accountability for these is centered at the corporate or division level. However, managers in smaller companies tend to be charged with a wider range of responsibilities since there are fewer numbers of specialized personnel on the payroll. Further, large manufacturing company executives often have access to specialized attorneys who are employed or retained by the employer. This favorable circumstance is less common in smaller enterprises. The various regulations impact many different business activities, are occasionally vague, and may have formidable ramifications for the company. (Edlin, 2002). Thus, managers should stay acquainted with these restraints and the manner in which federal officials administer them. Manufacturers should understand the law in order to preclude consequences such as fines, damages, injunctions, undesirable out-of-court settlements, and legal fees.

Top managers of small manufacturing firms cannot be charged with the responsibility of being familiar with all of the federal laws, of course (Zane, 2002). Instead, attorneys who are under the employ of, or are retained by the firm, should be accountable for this function. Conversely, managers are well advised to possess a general knowledge of the more fundamental laws and legal precedents and to be aware of conditions where it is necessary to consult attorneys (Delaney, 1999).

The study described herein assessed the degree to which a sample of chief executive officers of small manufacturing companies could accurately discriminate between a number of legal and illegal activities. It also examined differences in cognizance of legality between managers employed by

producers of industrial and consumer goods. Evidence has shown that federal authorities are more likely to prosecute consumer than industrial goods marketers (Lashgari, 2003). It follows that managers in this sector would go to further lengths to become aware of the law than industrial goods producers.

A sample of CEO's of small manufacturing firms received a listing of activities and was requested to assess the list and to indicate the degree to which they perceived each one to be legal or illegal. The analysis also assessed the extent to which these perceptions were accurate or not.

The study was directed at two hypotheses. These were as follows:

*H1: Chief executive officers of small manufacturing companies will be able to accurately identify, as legal or illegal, fifty percent or more of a list of activities that are potentially illegal.*

It is reasonable to expect that numerous C.E.O.s of small manufacturers are aware of the fact that federal regulations impact many of the actions they undertake in performing their work (Debble, 2001) and that failure to comply with the regulations can result in undesirable consequences (Joyner, Payne, & Raiborn, 2002; Williams & Barrett, 2000). Hence, there is considerable incentive for the C.E.O.s to familiarize themselves with and to act in conformity with these regulations (Petty, 1999; Gilliland & Manning, 2002).

The more than fifty-percent accuracy criterions specified in the hypothesis derives from the proposition that this proportion is the most neutral percentage available and, by default, demarks the mid-point between what might be construed as "naive" on the one hand and "knowledgeable" on the other. This criterion has also been employed in previous studies of the ability of managers to assess the legality of business activities (Peterson, 1998).

*H2: Chief executive officers of small manufacturing companies selling consumer goods will be more accurate than their counterparts that sell*

*industrial goods in assessing the legality of a set of activities that are potentially illegal.*

Research studies have identified differences in managerial practices and learning insights among managers of firms producing consumer versus industrial goods (Lilien, 1987). These suggest that business markets are different from consumer markets in terms of their characteristics and influences, decision processes, and relationships (Avlonitis & Gounaris, 1997). These findings also suggest that inter-industry differences could arise in the knowledge of federal law.

Industrial goods companies deal with a smaller number of customers, suppliers, intermediaries, and other parties than do consumer goods firms (Gummesson, 1999). In turn, the industrial goods firms rely heavily upon developing relationships with their constituencies, where reliance is upon trust and focus on constituency needs, and are less upon involvement in interactions that depend upon legal enforcement (Gounaris & Avlonitis, 2001). These concerns focus less on individual transactions and more upon developing permanent relationships. It is logical to expect that industrial goods firms will show greater responsiveness to long-term orientations of existing and potential constituencies by adopting a long term perspective in handling and dealing with them.

Research indicates that regulation tends to be more extensive and intensive for industries which are associated with a high level of public concern ((Banerjee, Lyer, & Kashyap, 2003). Consumer goods industries, of course, are comprised of companies that provide products to and interact with members of the public through functions such as promotion, pricing, and merchandising. In addition, industrial goods firms place less reliance upon advertising – a highly regulated function – in their marketing strategies than do consumer goods producers (Simkin, 2000). Thus, it can be expected that public concern is substantial for this sector.

Taking these various factors into account, it becomes apparent that there is substantial

inducement for C.E.O.s of firms in the consumer goods sector to become cognizant of legislation which might affect them.

## THE STUDY

Cover letters and accompanying questionnaires were forwarded to fifty randomly selected professors, one in each state, who taught a small business institute or similar course. The sample frame was the *Membership Directory: International Council for Small Business* (2002). The professors were selected from the directory, and if they taught a relevant course and elected to participate in the survey, they received a packet of 10 questionnaires to be distributed to C.E.O.'s of small manufacturing firms - five industrial and five consumer goods producers - in their geographical area. Many of these were past or present clients of small business institute or similar programs.

One week prior to receiving the questionnaire, each manager was mailed a postcard that asked for participation in the study and announced that a professor would soon deliver a questionnaire. The instructions were to complete the questionnaire and to mail or fax it back to the professor. This effort yielded a total of one hundred and sixty-five returned questionnaires. A follow-up postcard and a second questionnaire were sent to managers who did not respond. This second wave yielded seventy-nine additional usable completed questionnaires. Hence, the final sample size was 244 - a response rate of 48.8 percent.

The manufacturers were asked to indicate if fifty percent or more of their revenues emanated from (A) consumer or (B) industrial goods in order to allocate the respondent to the appropriate industry grouping. The sampling efforts yielded 162 consumer and 82 industrial goods producers.

The questionnaire employed in the study outlined twenty activities that managers employed by small manufacturing companies might undertake in their daily activities. These activities emanated from a prior study of retailer perceptions of legality (Peterson, 1998) and from a content analysis of chapters relating to regulation, social

responsibility, and ethics in five top-selling management policy textbooks.

Half of the activities are violations of federal laws or have been so interpreted by the courts. These activities are defined in the appendix. In turn, the definitions were provided to the respondents, so that they might comprehend the exact meaning of each one. The second half of the activities were not violations of federal laws, although some small manufacturer C.E.O.'s might perceive them as being unethical. These legal activities are also described in the appendix.

The instructions requested that the sample members indicate their opinion of the legality of each activity on a five-point scale that was anchored by the descriptors "obviously illegal", "probably illegal", "gray area", "probably legal", and "obviously legal" assessed against federal legislation. The sample members were only requested to respond to the legality issue. They were not required to assess the extent to which the activities were ethical or socially responsible.

The first hypothesis held that the C.E.O.'s, as a group, could accurately assess the legal status of fifty percent or more of the twenty activities. Fifty percent was selected because it is the most neutral proportion available and, by default, marks the mid-point between what might be construed as "naive" on the one hand and "knowledgeable" on the other. This percentage has been utilized in other studies of perceptions of the legality of business activities (Peterson, 1998).

Quantitative values were assigned to each of the five portions of the scale, and these values ranged from five (for "obviously illegal") to one (for "obviously legal"). The values which were allocated to each class were multiplied by their frequencies and divided by the number of respondents to yield arithmetic means for each of the twenty activities. Thus, a mean value of four for a particular activity signaled that the sample members believed the activity was "probably illegal." The mean values for each of the twenty activities are set forth in Table 1.

The data in the table indicate that the respondents, as a group, misclassified the legality of eight activities:

- Predatory pricing
- Agreeing to divide market with rivals
- Exercising surveillance over who supports a union formation
- Telling customers they are getting a price break when this is untrue
- Agreeing with distributors on the prices they will charge
- Pre-empting potential competition with prices below costs
- Inducing price discrimination
- Making sales forecasts based upon managerial judgment

Seven of the inaccurately-evaluated activities are illegal, but the members of the sample classified them as legal. On the other hand, only one was legal but was categorized as illegal. It appears that the primary distortion is in the nature of being unaware of federal prohibitions, rather than inaccurately concluding that certain activities are not in conformity.

The C.E.O.'s were able to make accurate classifications for twelve activities. Hence, they correctly categorized sixty percent of the legality relationships, which furnishes a measure of defense for hypothesis one. However, their collective response was inaccurate in forty percent of the cases, and most of these inaccurate perceptions are in the domain of regulations that are associated with strong penalties, including substantial fines, restrictive injunctions, and even possible imprisonment.

All but two of the inaccurate perceptions relate to antitrust legislation, assuming that the Federal Trade Commission Act is included in that assortment. Since antitrust laws can dictate substantial penalties, inaccuracies pertaining to these statutes can be extremely expensive to the firm.

Five of the activities which the members of the sample perceived inaccurately pertain to pricing. This suggests that the C.E.O.'s are less than fully cognizant on the legislation

**Table 1 - Respondent Belief of the Legality of Specified Activities**

Activity*	Mean Scale Value	Actual Legal Status
Refusing to hire job applicants who are over age 45	3.7	Illegal
Price collusion with competitors	4.0	Illegal
Charging higher prices than rivals	2.4	Legal
Hiring only experienced help	1.8	Legal
Predatory pricing	2.2**	Illegal
Informing a debtor that legal action may be pursued	1.9	Legal
Discharging an employee for filing an OSHA complaint	4.1	Illegal
Charging the same price to similar buyers	2.2	Legal
Suggesting that customers buy an item now	3.1	Legal
Agreeing to divide market with rivals	2.4**	Illegal
Exercising surveillance over who supports a union formation	2.0**	Illegal
Telling customers they are getting a price break when this is untrue	2.3**	Illegal
Selling a low quality product	3.1	Legal
Aiming the marketing effort only on larger customers	2.5	Legal
Selling products in throw-away non-degradable containers	2.3	Legal
Agreeing with distributors on the prices they will charge	2.2**	Illegal
Preempting potential competition with prices below costs	2.0**	Illegal
Inducing price discrimination	2.3**	Illegal
Promoting only experienced people into management jobs	3.1	Legal
Making sales forecasts based upon managerial judgment	3.8**	Legal
*The actions were described in detail in the questionnaires		
**Signifies that respondents' mean scale value on an activity was in error, as regards legal status. Significant differences between mean scale values and 3.0 were assessed by <i>Tukey K</i> tests at the .05 level.		

which relates to this function. Yet, pricing serves as an important ingredient in the marketing strategies of numerous small business manufacturers (Busch & Tincher, 1998).

A second portion of the study involved assessing the dependent variable by the nature of the offerings of the firm – industrial and consumer goods. It was hypothesized that managers employed by consumer goods firms would be more accurate in assessing legality than producers of industrial goods. Table 2 presents the relevant data. As in the case of Table 1,

*Tukey K* tests were employed to assess the data among the columns. A similar test was utilized to measure the significance of the differences between mean scale values of producers of consumer and industrial goods.

The data in Table 2 provide support for the second hypothesis. Both consumer and industrial good C.E.O.'s were incorrect in judging eight activities. In five of these, however, the difference between the mean scale values of the two groups is statistically significant. And, in each of these, the consumer goods C.E.O.'s mean scale values are closer to the actual legal status value than are the industrial goods C.E.O.s. Further, there are two activities for which both groups of executives made correct legal judgments, but there is a statistically significant difference between the mean scale values of both groups. In both of these cases, the consumer goods mean scale value is closer to the actual legal status value. Based upon this data, it is reasonable to conclude that the consumer goods C.E.O. possessed the highest degree of knowledge of the federal laws.

**Table 2 - Respondent Belief of the Legality of Specified Activities, by Type of Firm**

Activity*	Mean Scale Value		Actual Legal Status
	Cons. Goods	Indust. Goods	
Refusing to hire job applicants who are over age 45	3.9	3.6	Illegal
Price collusion with competitors	4.3	3.4 <sup>^</sup>	Illegal
Charging higher prices than rivals	2.3	2.6	Legal
Hiring only experienced help	2.0	1.7	Legal
Predatory pricing	2.4**	1.8** <sup>^</sup>	Illegal
Informing a debtor that legal action may be pursued	1.9	1.9	Legal
Discharging an employee for filing an OSHA complaint	4.3	4.0	Illegal
Charging the same price to similar buyers	2.1	2.4	Legal
Suggesting that customers buy an item now	3.0	3.3	Legal
Agreeing to divide market with rivals	2.6**	2.0** <sup>^</sup>	Illegal
Exercising surveillance over who supports a union formation	1.9**	2.3**	Illegal
Telling customers they are getting a price break when this is untrue	2.4**	2.1**	Illegal
Selling a low quality product	3.1	3.1	Legal
Aiming the marketing effort only on larger customers	2.2	2.8 <sup>^</sup>	Legal
Selling products in throw-away non-degradable containers	2.0	2.5	Legal
Agreeing with distributors on the prices they will charge	2.5**	1.5** <sup>^</sup>	Illegal
Preempting potential competition with prices below costs	2.2**	1.6** <sup>^</sup>	Illegal
Inducing price discrimination	2.5**	1.7** <sup>^</sup>	Illegal
Promoting only experienced people into management jobs	3.1	3.2	Legal
Making sales forecasts based upon managerial judgment	3.8**	3.8**	Legal
*The actions were described in detail in the questionnaires			
**Signifies that respondents' mean scale value on an activity was in error, as regards legal status. Significant differences between mean scale values and 3.0 were assessed by <i>Tukey K</i> tests at the .05 level.			
<sup>^</sup> Signifies that action mean scale values for consumer and industrial goods producers are significantly different.			

## DISCUSSION

The objective of this study was to assess the extent to which a sample of small manufacturing company C.E.O.'s were able to accurately distinguish legal and illegal activities, as they are set forth in federal legislation. For the sample at large, the managers were able to accurately designate the legality of the activities in sixty percent of the cases. A contrast between the C.E.O.'s of industrial goods and consumer goods small manufacturing firms suggested that consumer goods managers were more accurate in classifying legal and illegal activities than were industrial goods managers.

The results of the inquiry signify that some C.E.O.'s of small manufacturing firms, especially those producing industrial goods, may be in need of further training and education in federal supervision of their practices. If these companies do not acquire further knowledge, they and their top administrators are vulnerable to prosecution by the government and lawsuits imposed by competitors, customers, suppliers, distributors, unions, employees, and others.

The present inquiry concentrated on federal regulation. It is highly possible, however, that the managers are just as ill-informed on the legitimacy of business activities, relative to state and local laws. Additional studies

that assess the degree of managerial comprehension of these restraints could be of value.

C.E.O.'s in these companies could benefit through assessing the extent to which they are familiar with federal, state, and local law. Other regulations, beyond those examined in this study, could be evaluated through the measurement endeavor, depending on the specific legal environment which the company faces. If the measurement effort uncovers gaps in knowledge, remedial efforts can be instigated to improve upon the state of knowledge. These efforts could include consultations with well-informed attorneys, enrolling in classes and management development seminars, and reviewing business law literature. The outcome of carefully planned measures could be business decisions that are more compatible with the inevitable accretion in the intensity and latitude of regulation.

In addition to acquainting themselves about pertinent regulation, C.E.O.'s of small manufacturing firms can benefit through initiating procedures designed to familiarize key employees with this subject matter. Key employees may pursue strategies and tactics that are not congruent with the law, thereby placing the firm in a vulnerable position. Hence, they should have knowledge of the laws and be cognizant that top management is heavily motivated to comply with the law. Management is well advised to assess the degree of legal knowledge possessed by key employees and to consider means of edifying these individuals, should they be deficient in legal knowledge. If they are not well-informed, their performance may have to be carefully monitored and corrected, and this can be a time consuming activity that is normally beyond the province of top management responsibility.

Experience indicates that formal legal compliance management programs can be very useful in directing the behavior of employees. These focus on awareness of legal issues. Regardless of their values, employees cannot be expected to be intimately familiar with all of the laws and regulations that influence their work.

However, if employees are aware of relevant legal issues, they are more likely to raise the right questions and ultimately do the right thing when faced with a dilemma. Often, employees do the wrong thing simply because they are unaware – they do not know that they should be concerned or ask for help. Effective legal compliance management can increase employee legal issue awareness (Pruzan, 1998).

Legal compliance programs can be designed with different orientations. One orientation is a compliance-based approach, which focuses mainly on preventing, detecting, and punishing violations of the law. Another orientation – the values-based approach – attempts to define company values and encourage employee commitment to ethical aspirations. The values based approach can be advantageous since it is based on personal self-governance and is more likely to motivate employees to behave in accordance with shared values rather than avoiding punishment (Paine, 1994).

Under a value-based approach, the spirit of the law is a more stringent standard than the letter of the law (one does not seek to exploit potential loopholes discovered in the law). First management clearly and fully communicates the guiding values and commitments of the firm. All employees are urged to take these guidelines seriously and be comfortable with dialogue surrounding them. Management is personally committed to these values and is willing to act accordingly. In turn, managers are willing to review and assess their own behavior. Consistency in decision-making is essential to avoid employee cynicism and rejection of the compliance program (Joyner, Payne, & Raiborn, 2002).

When employees realize that they are facing a legal compliance issue, effective compliance management should make it more likely that the employees would ask for help and guidance within the firm. Many compliance managers devote much of their time responding to questions regarding company policy and the law. Providing good advice early can solve problems early and provide employees with accurate guidance

on company policies and the law. It can also furnish input that may be employed to plan future training needs or revisions in ethical codes (Gaumnitz & Lere, 2002; Emmelhainz & Adams).

Ideally, the legal compliance program is perceived by employees as concentrating on shared organizational values and guiding employees to act on their aspirations. Such programs motivate employees to be aware of legal issues, report bad news to management, and refrain from engaging in illegal conduct. This can reduce illegal behavior, enhance employee commitment, and generate employee perceptions that decision making in the company is better because of the legal compliance program. The program can be supplemented with an orientation toward satisfying external constituencies. Valuing external stakeholders, such as customers and the public at large can exert a positive impact on all outcomes (Trevino, Weaver, Binson, & Toffler, 1999).

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## APPENDIX

### Description of the Activities Covered

- 1. Refusing to hire job applicants who are over age 45.** Extending a policy where no individual who is 45 years of age or older will be hired for a given job category.

2. **Price collusion with competitors.** Making agreements with rival manufacturers which stipulate the prices each competitor will charge to its customers.
3. **Charging higher prices than rivals.** Assessing company customers higher prices than those assessed by competitors to their customers.
4. **Hiring only experienced help.** Hiring only those job applicants who have personal experience in manufacturing work.
5. **Predatory pricing.** Setting company prices at low levels in order to drive competitors out of business.
6. **Informing a debtor that legal action may be pursued.** Telling a debtor, by telephone or letter, that if a past-due account is not settled, legal proceedings may be put into motion.
7. **Discharging an employee for filing an OSHA complaint.** Firing an employee because that individual has filed a complaint with the Occupational Safety and Health Administration regarding an unsafe practice or facility at work.
8. **Charging the same price to similar buyers.** Charging identical prices to different company customers when these customers are essentially alike in terms of the cost of serving them.
9. **Suggesting that customers buy an item now.** Urging immediate purchase as prices may rise sometime in the future.
10. **Agreeing to divide the market with rivals.** Reach an agreement whereby you will not compete for certain customers reserved for competitors and they will not compete for certain markets reserved for your firm.
11. **Exercising surveillance over who supports a union formation.** When efforts are being made to form a union in your plant, undertaking to discover which employees are in favor of the union.
12. **Telling customers they are getting a price break when this is untrue.** Falsely informing customers that they are receiving a price that is lower than that charged to other customers.
13. **Selling a low quality product.** Sell a product that is inferior in performance, materials, or workmanship to products sold by competitors.
14. **Aiming the marketing effort only on larger customers.** Concentrating your marketing personnel and activities on satisfying the needs of your larger customers.
15. **Selling products in throw-away non-degradable containers.** Selling goods in packages that will not break down into natural commodities in a reasonable period of time.
16. **Agreeing with distributors on the prices they will charge.** Entering into contracts with distributors whereby the distributor agrees to sell your items at the prices you have specified.
17. **Preempting potential competition with prices below costs.** Keeping new firms from entering your market by pricing below costs, making it impossible for new firms to make a profit.
18. **Inducing price discrimination.** Persuading a supplier to sell goods to you at a lower price than that paid by a similarly situated competitor.
19. **Promoting only experienced people into managerial jobs.** Promoting into managerial level jobs only those who have extensive experience with the company.
20. **Making sales forecasts based upon managerial judgment.** Preparing sales forecasts that are based upon the experience and judgment of management, rather than upon mathematical calculations.