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THIRD EDITION

*Foundations of the* **LEGAL**  
**ENVIRONMENT**  
*of* **BUSINESS**



MARIANNE M. JENNINGS



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**ENVIRONMENT**  
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MARIANNE M. JENNINGS

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# *Dedication*

*To my roots, my mother and father, and to my branches, sprouts, gardeners, and inspiration,  
my husband and children, Terry, Sarah, Sam, John, and our beloved Claire and Hannah*







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## World of Daily Legal and Ethical Issues

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In late 2009, just as the second edition of this book was going to press, Goldman Sachs' CEO, Lloyd Blankfein, uttered the same words that Enron's former CEO, Jeffrey Skilling, did in 2000: "We are doing God's work." Mr. Blankfein was responding to the questions about banking practices, risks, and compliance with laws and regulations that followed the 2008 market collapse. Now, as this third edition goes to press, JPMorgan Chase has paid nearly \$700 billion in fines related to complex debt instruments and disclosures about the mortgages underlying them, a rogue trader at the bank who lost \$6 billion, and alleged price-fixing by bank traders. Even among government regulators, there are serious questions about compliance with the law. Under continuing investigation is the scrutiny of certain selected taxpayers by the Internal Revenue Service, the Justice Department's tapping of phones of news corporations, and the NSA's scope of surveillance of citizens' phone records and electronic messages. Apple and several major book publishers signed antitrust consent decrees for agreeing to fix prices in order to compete with Amazon. A factory in Bangladesh, which produced clothing for U.S. retailers, collapsed, killing over 600 employees—a collapse that was caused by noncompliance with safety and code standards.

The patterns of business behavior that push the envelope of law and ethics continue. A good portion of the members of the New York legislature were indicted on corruption charges, companies from Ralph Lauren to Avon paid fines for violations of the Foreign Corrupt Practices Act, and BP paid the largest fines in U.S. history for the safety and environmental violations that resulted from the explosion of its Deepwater Horizon oil rig in the Gulf. Colleges and universities struggled with terminations of coaches for everything from losing to the failure to supervise the criminal activity of assistant coaches. The issues of law and ethics are still at the forefront of business, sports, and government. It has become a tall order just to keep up with all the events!

These companies and organizations and their employees and executives certainly could have benefited from understanding and keeping at the forefront of their decision processes the basics of law and ethics! The legal and ethical environments of business are center stage. Several editions ago, Congress made massive regulatory reform a reality with the passage of the Sarbanes–Oxley legislation on corporate governance, accounting regulation, and criminal penalties. But the SEC missed Bernie Madoff's \$50 billion Ponzi scheme for 18 years and Congress passed additional reforms for financial market regulation in 2010. Credit card solicitations, billing, and terms have changed completely and are now under a new Consumer Protection Bureau housed within the Federal Reserve so that all aspects of credit cards are now consolidated and regulated in one place. Business is even more international, and we are witnessing the need for thoughtful legal and ethical

analysis as companies enter new markets. Even Apple struggled with backlash from conditions in its supplier's factories. Suicides and child labor at Foxconn damaged the Apple brand. There were so many FCPA cases that the Justice Department issued new guidelines to help companies better construct their compliance programs for controlling bribes in international operations. The world and business continue to change and grow, but law and ethics have retained their role and importance.

In fact, now more than ever, we need to understand the legal and ethical issues that affect our businesses and our lives. The knowledge base and even the questions in law and ethics remain the same, but the underlying facts have changed. For example, we still debate the social responsibility role of business. Now we raise that issue in the context of whether Apple and Google should take advantage of offshore tax loopholes, and whether U.S. companies should engage in a tax inversion—the merger with a foreign company to escape higher U.S. tax rates. We continue to delve into the pros and cons of sending production to other countries. We still have the question of when a contract is formed, but now we face that question with “point and click” technology rather than faxes and letters. We continue to be concerned about our privacy as consumers, but now we wonder who really has access to our Facebook page and whether scientists are testing our emotions through that site. We still wonder about the extent of copyright law. The file-sharing programs have never quite gone away and the film industry now litigates the downloading of copyrighted films. The world is different, but law and ethics form the constant framework into which we fit the issues of the day. In the materials that follow, you have the chance to understand the marvelous stability of this framework and the ease with which you can apply it to this very different world.

## Building the Bridge: Applying Legal and Ethical Reasoning to Business Analysis

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Some students at a major university recently completed their final exam—a review of the legal and ethical issues a company in Australia was facing. The exam was one I had written as a case study. These students are in the second year of their masters degree studies. They have been trained in economics, marketing, management, and finance. But as they completed their analyses of what went wrong and why with this company, they had an epiphany. A company can get the finance issues right (this company was saving money on taxes by locating in Australia), have great demand for its product, and even yield terrific revenue results. However, they realized from the facts about the company that it can all fall apart over the legal issues. There were questions about its sale of securities in other countries, whether its financial statements complied with U.S. standards, and whether its use of another company's technology was infringement of a copyright. There were even questions about its ads and comparisons to its competitor's products because those competitors were crying “foul” and asking for regulators to step in and force corrective ads. There were also questions about the security of their operations and the problems with cloud services. Issues such as these show up in the news for companies around the world and then affect customer relations, regulatory actions, and, as a result, stock prices. The students were well trained in economic theory, supply chain management, cash flow issues, and market capitalization. They are very capable *business* students. However, they did not realize until this final exam how much of business turns on anticipating the legal issues and getting them resolved correctly. They also



realized that all of our discussions of ethics and social responsibility have a critical role in doing business and in making business decisions.

TANSTAAFL—“There ain’t no such thing as a free lunch” when it comes to the gains we make. There are costs to international expansion and the use of data mined from users. Those costs come from legal issues, which, if handled poorly, can affect a company’s value and tarnish its brand name.

Why couldn’t these students see the interconnection and critical roles of law and ethics in business until this case for their final? It was not for lack of exposure to the law. Their professor had taught her course “by the book,” so to speak. Students could recite the components of a valid contract, rattle off the requirements for bankruptcy, recall from memory the antitrust statutes. Yet, the realization that came from the students’ reaction to the exam was that rote knowledge was not enough. One of my best former students, who had gone on to medical school, came to me perplexed about her office lease. She said that the complex in which she wanted to open her practice had a “no advertising” policy. In fact, she said that when she toured the premises with a leasing agent, the leasing agent turned to her and said, “You’re not one of those doctors who advertises, are you? Because if you are, we can’t lease to you. We have a policy against it.” One of my best students, who knew the antitrust statutes well, could not apply them to her everyday business. Worse, perhaps, she could not *recognize* when to apply these statutes: She did not see the antitrust implications of the agent’s statements nor the problems with the physicians in the complex taking such an approach to screening tenants.

I have reached the conclusion that there are shortcomings in the standard approach to teaching business students law and ethics. Students are not ignorant of the law after finishing a legal environment course; rather, they simply lack the necessary skills to recognize legal and ethical issues and to apply their knowledge of law and ethics to business decision making. As instructors, we are simply not integrating legal and ethical reasoning with business analysis. This concern about practical application led me to develop my own materials for classroom use decades ago and eventually led to the publication of the book, *Business: Its Legal, Ethical, and Global Environment*, now in its tenth edition. But, when I went back to teaching undergraduates at the sophomore level, I realized that book could be further adapted for the undergraduate level. These undergraduates, often studying this subject area in lower-division courses, need less material, more help with problem solving, and a different way of summarizing the material in the chapters. So, this book was born to serve the needs of this generation of undergraduates. The first edition proved that its approach was needed. Based on feedback from the first and second editions, we have taken input from professors and students to make the approach better.

The same bridge approach from the legal environment book is here, but the sentences are shorter and complex terms and ideas are presented in a more accessible manner. For all areas of law and ethics, this book answers the question: How does this concept affect a business? This book builds a bridge between knowledge of law and ethics and application of both in business. My 38 years of teaching law and ethics finally brought this realization: business ethics is not easily grasped nor practiced in business because we depersonalize ethical issues. If we just allow the company or organization to make the decision, our ethics are not in question; the company’s are. The ethical issues in the book require students to bring ethical issues into their lives, their circumstances, their world. This feature also forces them to answer this question in a wide variety of contexts, “If it were you, and

you were faced with the dilemma and required to make a decision, what would you do?”

## Up-to-Date Content, New Approaches, Business Applications, and Learning Aids

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The organizational structure of this edition has been changed yet again to respond to feedback from faculty who teach at the undergraduate level. There are four parts to the text and each part begins with an overview that helps students see the importance of these areas of the law in running a business. Part 1 offers the student an overview of the legal, ethical, and judicial environments of business. Part 2 covers the regulatory environments of business. It also includes the addition of sustainability in the environmental chapter. Part 3 covers the illegal environment of business relationships including contracts and the supply chain. In this restructuring, the relationships with customers and competitors have been moved into this section. Included are the marketing and credit relationships with customers as well as the product safety responsibilities to them. This section deals with every interaction between businesses and their customers. Part 4 covers the legal and ethical issues in business operations, covering everything from employee rights and responsibilities to the same topics for business owners, partners, and shareholders. This portion of the text has been reorganized to place agency, business structure, and securities law all together in a smoother flow, with the chapters focused on employment issues placed at the end of the book.

This new structure allows students to build their knowledge of law in a logical and gradual way. Once we understand the legal system, we can study specific topic areas such as environmental and tort law. And after we have an understanding of the general areas of the law, we can move into the specific legal areas that affect business relationships and operations. This new order of topics and chapters provides a logical sequence of study.

### ETHICS

Business Ethics and Social Responsibility (Chapter 2) offers up-to-date examples and insights on the application of ethics to business decision making. Chapter 2 is chock full of the examples the last several years have netted—from marathoners taking the subway to have a faster finish time to a “Guess Who?” quiz on the companies that collapsed and the irony of their conduct *and* statements. Ethics coverage is also integrated throughout all chapters through at least one ethical issue for discussion in each chapter.

## Business Applications and Learning Aids

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### CASE HEADLINES

Every court case has a case headline that summarizes what issues are involved in the case. In The Court System and Dispute Resolution (Chapter 3), students read *Kroger Co. v. Walters*, a case that addresses the issues of our obligations regarding evidence for a potential civil suit. In the case, a customer is injured when he slips on

a banana and is injured. The case title is memorable: “A Slip on the Banana Video.” In Chapter 17, the Zicam securities fraud case, based on the company’s failure to disclose that its product was causing a loss of smell in users, has the title, “Missing Disclosures by a Nose.” The vivid one-line description and colorful facts of the case, a common thread throughout the case choices in the text, help students internalize the rules and lessons about not destroying evidence for a potential lawsuit.

## CHAPTER OPENERS

Chapters begin with an opening “Consider...” problem, which presents a legal dilemma relevant to the chapter’s discussion and similar to those business managers need to handle. These are revisited and answered in the body of the chapter. For example, Chapter 19’s opening “Consider...” problem presents the facts in an age discrimination case in which a reporter was denied the right to cover fashion because she was a grandmother. Moreover, many of the answers to these opening problems appear in the chapter in the form of the case decision that addressed the teaser issue that the opening “Consider...” problem raises. The student is intrigued by a problem presented as the chapter opens, gets an opportunity to see how a court would resolve that issue, and then has the chance, through additional “Consider...” problems and the chapter problems, to solve more problems with the newfound knowledge and skills. These answers provide a step-by-step approach for students to use their new knowledge and skills as they solve the problems, an approach they can also use for solving the chapter problems.

The chapters also have the common element of opening statements that discuss the major topics of the chapter and present the general goals for the chapter in the form of questions to be answered. Finally, as part of the chapter beginnings and a trademark of the Jennings’ approach to education, are the quotations, often humorous, that pique students’ interest and focus the chapter to the major issues.

## RED FLAGS FOR MANAGERS

Each chapter concludes with an innovative summary of what the chapter covers. This learning tool evolved after discussions with faculty and students on how learning takes place. Both groups wanted a tool that gave them the chapter’s key points and, true to the application focus of the book, why and how those key points mattered. For example, the following is an excerpt from the Red Flags in Chapter 3 on the Court System and Dispute Resolution. If you can make this topic real for students, think what the red flags in torts and crimes will do:

*Managers should make sure they turn over all necessary documents and evidence and should always tell the truth in depositions and during the trial. Managers should also take care to preserve evidence that relates to a dispute. Evidence that is lost could be a critical part of the company’s case, and the fact that it is lost can be used against the company.*

## Thinking, Applying, and Reasoning: Organization and Features

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The text is organized in a logical flow for students.

### ORGANIZATION

There are four parts in the book, which serve to organize the materials around business operations. Every chapter integrates international and ethical topics.

**Part 1**

In three chapters, Part 1 offers an introduction to law, an introduction to business ethics and the judicial system, and a discussion of litigation and alternative dispute resolution. Part 1 provides students with a foundation in law and ethics, as well as legal and ethical reasoning, necessary for the areas of law in the chapters that follow. By being brief (three chapters), Part 1 offers instructors an early and logical break for exams.

**Part 2**

In six chapters, Part 2 covers the regulatory environment of business, including the following topics: constitutional law, administrative and international law, business crimes and business torts, and environmental regulation. At the completion of Parts 1 and 2, students have a grasp of the legal system, ethical boundaries, and the general regulatory laws that affect business. Cyberspace topics are featured in all chapters throughout the book, but you can find the privacy issues, computer crimes, and even cyberbullying in these chapters. This edition has necessarily expanded the cyberlaw coverage because, well, cyberlaw issues are an increasingly important part of business operations, in everything from employee monitoring to customer outreach.

**Part 3**

The five chapters in Part 3 present students with the legal and ethical issues in business relationships. This portion of the book deals with the legal issues in business interaction with customers and competitors. Part 3 includes all contract topics, including the areas of law involved in managing the supply chain and distribution. This edition has side-by-side coverage of the laws that apply to customer relationships, from marketing and advertising through to the credit agreements. However, customer relationships often turn on the quality and safety of the business's product. So, this new restructuring combines that topic in with the full range of issues in customer service and relationships. Part 3 also covers the relationships of a business with other businesses. From antitrust law to intellectual property protections, tense competition defines the need for knowledge about legal boundaries. This structure puts the issues that evolve with competitors into one section that allows instructors to discuss the overall notion of fairness in competition, whether it be an issue of price-fixing or the unauthorized use of a trademark to gain customers.

**Part 4**

The five chapters in Part 4 cover the internal operations of business: dealing with employees and making sure that those who finance the business, the owners, partners, and shareholders are protected. Topics covered in this operations section include agency law and employee conduct, management of employee welfare, and employment discrimination. Grouped together for the first time in this edition are the three chapters on agency, business structure, and business financing through the sale of securities. Partnership liability, corporate governance, and SEC requirements all blend together as the integrated chapters help students grasp the basics of financing a business and honoring obligations to those who provide that financing.

**FEATURES****Court Cases**

Edited court language cases provide in-depth points of law, and many cases include dissenting and concurring opinions. Case questions follow to help

students understand the points of law in the case and think critically about the decision. The courts have been active in their business dockets, and there are many 2012–2014 case decisions throughout the book. Students will be able to study the suit brought by a young woman who is paralyzed when her friend pulls her from her wrecked car because she thought she was helping. What happens if tests for promotion at work favor a certain race? Can employers use the tests? Can they throw out the results? What happens when a young man saves his Pepsi points to claim a Harrier Jet that he sees in a Pepsi spoof ad for “Pepsi stuff”? Does he get his jet? What happens if a company fails to tell its shareholders that it has been sued by a customer injured by the company’s primary product?

### **“Consider...” Problems**

“Consider...” problems, along with Ethical Issues and Business Planning Tips, are a part of every chapter. These problems, often based on real court cases, ask students to evaluate and analyze the legal and ethical issues discussed in the preceding text. Since the problems are integrated into the text, students must address and think critically about these issues as they encounter them. Through interactive problems, students learn to judge case facts and determine the consequences. The “Consider...” problems bring the most current topics into the book and the classroom. This book adds a novel feature for legal environment texts: THINK, APPLY, and ANSWER. At the end of each chapter, students are reminded of what they have just learned in the reading or the case via THINK. In the APPLY section, they are walked through how the case or principles just covered would apply in the circumstances presented in this problem. After they have walked through this system of reasoning, ANSWER gives them the solution. Students are then able to take the chapter problems and solve them using the THINK, APPLY, and ANSWER model on their own. This tool helps students to develop the legal and ethical reasoning skills that will give them a strong foundation for applying legal and ethical principles for the course and eventually in business.

### **Ethical Issues**

The Ethical Issues feature appears in every chapter and presents students with real-world ethical problems to grapple with. Ethical Issues help integrate coverage of ethics into every chapter. The ethical issues also include personal and real-life examples that help students relate to the pervasive nature of ethical dilemmas that they grapple with and will continue to face once they enter the business world.

### **Business Planning Tips**

Students are given sound business and legal advice through Business Planning Tips. With these tips, students who have now mastered the law and legal principles are trained to anticipate issues and ensure compliance.

### **Cyberlaw**

All chapters also include segments on cyberlaw. These chapter-by-chapter materials, indicated by an icon in the margin of the text, give students the chance to see how new technology fits into the existing legal framework.

### **Exhibits**

Exhibits include charts, figures, and business and legal documents that help highlight or summarize legal and ethical issues from the chapter. Many of the charts are either new or updated and provide users with a concise way of reviewing materials that makes the complex concepts manageable and memorable.

**End-of-Chapter Questions and Problems**

The end-of-chapter problems in this edition have been updated and/or changed. These new chapter problems throughout the book are varied in length for different instructor needs, but are always compelling examples for undergraduate students.

**Review Questions**

New to this edition are five to ten multiple choice questions at the end of each chapter that provide students with the opportunity to test themselves on their grasp of the chapter concepts *before* they have to take a test.

**The Informed Manager: Who Should Use This Book?**

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With its comprehensive treatment of the law, integrated business applications, full-color design, and its clear writing style, *Foundations of the Legal Environment of Business, 3rd Edition* is well suited for undergraduate students. This is a text designed to get students reading more than just the chapter summaries. Short paragraphs, thoughtful flow, and non-legalese writing have a way of grabbing students' attention and keeping them focused on the materials.

**A NOTE ON AACSB STANDARDS**

The strong presence of ethics, social responsibility, international law and issues, and the integration of other business disciplines make the book an ideal fit for meeting AACSB standards and curriculum requirements. The AACSB standards emphasize the need for students to have an understanding of ethical and global issues. The separate chapter on ethics as well as ethical issues and dilemmas for student discussion and resolution in every chapter offer a solid training for students. The separate chapter on international law is complemented by a chapter segment devoted to international law issues in that chapter's area of law. The text offers students insights into more nuanced international issues such as language in contracts, the role of lawyers in other countries, and evolving issues in the presence of pirates and increasing corruption.

This book provides students with the legal foundation necessary for business operations and sales but also affords the students the opportunities to analyze critically the social and political environments in which the laws are made and in which businesses must operate. Just an examination of the lists of the companies and individuals covered in the text gives an excellent overview of the compelling issues and cases the text covers. All of the materials were chosen to offer students a balanced look at regulation, free enterprise, and the new global economy.

**Supplements**

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*Foundations of the Legal Environment of Business, 3rd Edition* offers a comprehensive and well-crafted supplement package for both students and instructors. Contact your Cengage Learning Sales Representative for more details, or visit the Jennings website at [www.mariannejennings.com](http://www.mariannejennings.com).

**Instructor's Manual.** The Instructor's Manual, written by the author, provides the following for each chapter: a detailed outline; answers to "Consider..." problems, Ethical Issues, Case Questions, and the end-of-chapter Questions and Problems;



briefs of all cases; interactive/cooperative learning exercises; and supplemental readings. Available on the book's companion website.

**Microsoft PowerPoint® Lecture Slides.** Developed by the author, PowerPoint slides are available for use by students as an aid to note taking, and by instructors for enhancing their lectures. Available on the book's companion website.

**Test Bank.** The Test Bank includes more than 1,500 questions in true–false, multiple-choice, and essay format. Answers to questions provide a subject word for easy identification and a classification indicating if they are intended for review of concepts or for analysis and application of concepts. The questions vary in levels of difficulty, and meet a full range of tagging requirements, including AACSB standards. Available on the book's companion website.

**Cognero.** Cengage Learning Testing Powered by Cognero is a flexible, online system that allows you to:

- 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

Available on the book's companion website.

**CourseMate.** CourseMate brings course concepts to life with interactive learning, study, and exam preparation tools—including an e-book—that support the printed textbook. Revised for this edition, student study materials and a set of auto-gradable, interactive quizzes allow students to instantly gauge their comprehension of the material. Built-in engagement tracking tools allow instructors to follow students' study activities and assess their progress. Available to instructors and students within CourseMate is the KnowNOW! blog for Business Law, written by the author, which provides students with current events examples of legal concepts.

**Business Law Digital Video Library.** Featuring more than 100 video clips that spark class discussion and clarify core legal principles, the Business Law Digital Video Library is organized into five series: Legal Conflicts in Business (includes specific modern business and e-commerce scenarios); Ask the Instructor (presents straightforward explanations of concepts for student review); Drama of the Law (features classic business scenarios that spark classroom participation); Real World Legal (presents legal scenarios encountered in real businesses); and Business Ethics in Action (presents ethical dilemmas in business scenarios). For more information about the Digital Video Library, visit [www.cengage.com/blaw/dvl](http://www.cengage.com/blaw/dvl). Access for students is free when bundled with a new textbook or can be purchased separately. Students must register for and purchase access to the Digital Video Library at [www.cengagebrain.com](http://www.cengagebrain.com).







**Professor Marianne Jennings** is an emeritus professor of legal and ethical studies in business from the W.P. Carey School of Business at Arizona State University, having retired in 2011 after 35 years of teaching there. She continues to teach graduate courses in business ethics at colleges around the country, and returned to ASU to teach graduate courses in late 2013.

During her tenure at ASU, she served in many different capacities: director of the Joan and David Lincoln Center for Applied Ethics (1995–1999); faculty director for the MBA Executive Program (2006–2007); associate dean (1986–1987); chair of the University Hearing Board (1995–2011); and faculty athletic representative to the NCAA and PAC-10 (1986–1987).

Professor Jennings earned her undergraduate degree in finance and her J. D. from Brigham Young University. Her internships were with the Federal Public Defender and U.S. Attorney in Nevada, and she has done consulting work for law firms, businesses, and professional groups including AES, Boeing, Dial Corporation, Mattel, Motorola, CFA Institute, Southern California Edison, the Arizona Auditor General, the Cities of Phoenix, Mesa, and Tucson, the Institute of Internal Auditors, Coca-Cola, DuPont, Blue Cross Blue Shield, Motorola, Mattel, Pepsi, Hy-Vee Foods, IBM, Bell Helicopter, Amgen, Raytheon, and VIAD.

Professor Jennings has authored hundreds of articles in academic, professional, and trade journals. Currently she has six textbooks and monographs in circulation. The eighth edition of her textbook, *Case Studies in Business Ethics*, and the tenth edition of her textbook, *Business: Its Legal, Ethical, and Global Environment*, were published in January 2014. Her first textbook, *Real Estate Law*, had its tenth edition published in January 2013. She was added as a co-author to *Anderson's Business and the Legal Environment* in 1997, a text whose 22nd edition was published in January 2013. Her book, *Business Strategy for the Political Arena*, was selected in 1985 by *Library Journal* as one of its recommended books in business/government relations. *A Business Tale: A Story of Ethics, Choices, Success, and a Very Large Rabbit*, a fable about business ethics, was chosen by *Library Journal* in 2004 as its business book of the year. *A Business Tale* was also a finalist for two other literary awards in 2004. In 2000, her book on corporate governance was published by the *New York Times* MBA Pocket Series. Professor Jennings' book on long-term success, *Building a Business Through Good Times and Bad: Lessons from Fifteen Companies, Each with a Century of Dividends*, was published in October 2002 and has been used by Booz, Allen, Hamilton for its work on business longevity. Her book on organizational ethical culture, *The Seven Signs of Ethical Collapse*, was published by St. Martin's Press and continues to be used by many organizations as a framework for assessing culture. Her books have been translated into five languages. Her latest book, *Somewhere Between Ezekiel and Miss Havisham*, a book of essays on grief, was published in 2012.

Her columns have been syndicated around the country, and her work has appeared in the *Wall Street Journal*, *Chicago Tribune*, *New York Times*, *Washington*

*Post*, and *Reader's Digest*. A collection of her essays, *Nobody Fixes Real Carrot Sticks Anymore*, first published in 1994, is still being published. She was given an Arizona Press Club award in 1994 for her work as a feature columnist. She has been a commentator on business issues on *All Things Considered* for National Public Radio.

She has conducted more than 500 workshops and seminars in the areas of business, personal, government, legal, academic, and professional ethics. She has been named professor of the year in the College of Business in 1981, 1987, 2000, and 2010 and was the recipient of a Burlington Northern teaching excellence award in 1985. In 1999, she was given best article awards by the Academy of Legal Studies in Business and the Association for Government Accountants. She was given best article awards by the Institute of Internal Auditors and Association of Government Accountants in 2001 and 2004. In 2000, the Association of Government Accountants inducted her into its Speakers Hall of Fame. In 2005, she was named an All-Star Speaker by the Institute of Internal Auditors. In 2006, her article, "Ethics and Investment Management: True Reform," was selected by the United Kingdom's *Emerald Management Review* from 15,000 articles in 400 journals as one of the top 50 articles in 2005. She was named one of the Top 100 Thought Leaders by Trust Across America in 2010. In 2012, she was named one of the 100 Most Influential People in Business Ethics by *Ethisphere* magazine.

She is a contributing editor for the *Real Estate Law Journal*, *New Perspectives*, *The Smart Manager*, and the *Corporate Finance Review*. She served on the Board of Editors for the *Financial Analysts Journal* from 2007–2012. She served as editor-in-chief of the *Journal of Legal Studies Education* during 2003–2004. During 1984–1985, she served as then-Governor Bruce Babbitt's appointee to the Arizona Corporation Commission. In 1999, she was appointed by Governor Jane Dee Hull to the Arizona Commission on Character. From 1999–2009 she served as president of the Arizona Association of Scholars.

She is a member of twelve professional organizations, including the State Bar of Arizona, and has served on four boards of directors, including Arizona Public Service (now Pinnacle West Capital) (1987–2000), Zealous Capital Corporation, and the Center for Children with Chronic Illness and Disability at the University of Minnesota. She served as chair of the Bonneville International Advisory Board for KHTC/KIDR from 1994–1997 and was a weekly commentator on KGLE during 1998. She was appointed to the board of advisers for the Institute of Nuclear Power Operators in 2004. She has appeared on *CNBC*, *CBS This Morning*, the *Today Show*, and *CBS Evening News*.

Personal: Married since 1976 to Terry H. Jennings, Maricopa County Attorney's Office Deputy County Attorney; five children: Sarah, Sam, and John, and the late Claire and Hannah Jennings.



This book is the product of many fine ideas contributed by colleagues, students, friends, editors, practicing lawyers, and regulators. Listing all those who have engaged with the author in answering the questions, “What do business leaders need to know about law and ethics?” and “How can we best help students to learn?” would be impossible. But, there are those who served as reviewers and those who have provided ideas, cases, and suggestions for improvement and inclusion. For this new effort, the following colleagues offered their seasoned advice:

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Robert H. Doud, *Adelphi University*  
David H. Elibol, *SUNY–Buffalo*  
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Any new edition of a book carries the significant imprint of the editors who work to design, refine, market, and produce it. This first edition of this book began because of thoughtful conversations with my former editor, Steve Silverstein, who was concerned about students and wondered whether we were really helping undergraduate students in learning and their professors in presenting legal environment and ethical issues. When Steve accepted a wonderful opportunity for a different type of editorial work, Laura Bofinger took over the project. A leave for the delightful reason of a second child brought Jennifer King in to take over the arduous task of reining in an author who needs an editor to do so. Sarah Blasco has stepped into their shoes beautifully and efficiently. These are diligent and insightful people for whom the title of “editor” is not sufficient. They are efficiency experts, wordsmiths, schedule masters, and motivational coaches. Ann Borman got stuck with the day-to-day contact and author pestering and handled it all with patience and perfection. Authors cringe when editors say, “Try this,” or “How about reworking Part 2?” But editors have a vision and perspective that authors lack. Vicky True-Baker, Product Manager, joined us mid-first edition and has brought her ear-to-the-ground expertise to help with the restructuring for this edition. Kris Tabor has been with me for nearly 28 years, continuing her work on IMs, study guides, PowerPoints, and venting. We have lasted longer together than most marriages. This book also carries the unmistakable liveliness of an author who shares her life with helpful and delightful children and one tolerant husband. They have brought me stories, pop culture, and good sense with their, “Get real, Mom!” They bring me perspective and priorities. Even though our home is now an empty nest, they still ask how the books are going. They know the drill, so if I say I am in “second pages,” they know the end is in sight. I am finally grateful to my parents who taught me through their words and examples the importance and rewards of ethics and hard work.

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# Part 1

## BUSINESS: ITS LEGAL, ETHICAL, AND JUDICIAL ENVIRONMENT

Simply stated, you cannot run a successful business without knowing the law. What is legal? Where can I find the laws I need to know? How do I make decisions about legal conduct that is ethically troublesome to me? What if I have a disagreement with a customer, employee, or shareholder? How and where can I resolve our differences?

This portion of the book explains what law is, where it can be found, how it is applied, and how legal disputes are resolved. But beyond operating within the law, there are the ethical issues. Just because what you are doing is legal does not mean it is ethical. And why should a manager make ethical choices and behave honorably in business? Law and ethics are inextricably intertwined. A commitment to both is part of a sustainable business model.



You have probably been exposed to law through traffic tickets or through a problem with your landlord, your lease, or a roommate who failed to pay the landlord. Or perhaps a company you interviewed with looked you up on Myspace or Googled your name and discovered interesting information about you. Your experiences with law raise questions in your mind such as, “Who’s in the right here?” Each day legislatures and courts are trying to answer your questions as they deal with your rights and protections with landlords, other cars on the road, and information about you on the Internet. Social networks are terrific, but we have exposed ourselves, literally and figuratively, on YouTube and Myspace. Now what can we do?

Laws exist at every level of government because they are necessary for an orderly society. Laws require us to meet minimum standards of conduct. Traffic laws control not only our conduct when we are driving but also our relationships with other drivers using the roads. In some instances, we owe them the right-of-way and are liable to them for any injuries we cause by not following the traffic laws.

This chapter offers an introduction to law. How is law defined? What types of laws are there? What are the purposes and characteristics of law? Where are laws found, and who enacts them?

**UPDATE** 

For up-to-date legal news and real-world business applications, go to [mariannejennings.com](http://mariannejennings.com)



## Consider...

YouTube was founded in February 2005 by three former employees of PayPal. When YouTube was launched, a press release described it as a site that “allows people to watch, upload, and share personal video clips.” YouTube was so successful that within one year it was acquired by Google for \$1.65 billion. By March 2010, site traffic on YouTube had soared to more than 1 billion daily video views, with more than 24 hours of new video uploaded to the site every minute.

Viacom, other film companies, and copyright holders discovered that their films and other video materials were posted on YouTube and filed suit against YouTube and Google for copyright infringement. Google and YouTube maintained that those who posted the videos were responsible for infringement and that they only provided an Internet site and service. Are YouTube and Google responsible for the copyright infringement by others?

*This country's planted  
thick with laws from  
coast to coast . . . and if  
you cut them down . . .  
d'you really think you  
could stand upright in  
the winds that would  
blow then?*

**Robert Bolt**  
*A Man for All Seasons, Act I*

## 1-1 Definition of Law

Philosophers and scholars throughout history have offered definitions of law. Aristotle, the early Greek philosopher, wrote that “the law is reason unaffected by desire” and that “law is a form of order, and good law must necessarily mean good order.” *Black's Law Dictionary* defines law as “a body of rules of action or conduct prescribed by the controlling authority, and having legal binding force.” Law has been defined at least once by every philosopher, statesman, politician, and police officer.

Law is the body of rules governing individuals and their relationships. Laws give us basic freedoms, rights, and protections. Law also offers a model of conduct for our business and personal lives and provides us with some certainty. Businesses, people with contracts, and property owners rely on the law for consistent protection of rights. Without this consistent framework of law, society would be a mass of chaos, confusion, and uncertainty.

## 1-2 Classifications of Law

### 1-2a PUBLIC VERSUS PRIVATE LAW

**Public law** includes those laws enacted by some authorized governmental body. State and federal constitutions and statutes are examples of public laws. Public laws govern everything from the sale of stock (federal securities laws) to the height of a building (zoning laws).

**Private law**, on the other hand, is developed by individuals. For example, landlords usually have private regulations for their tenants, such as limits on what they

can put on their balconies. Homeowners' associations have developed an important body of private law that regulates everything from what type of landscaping can be used for homes in a subdivision to whether homeowners can install basketball hoops in their driveways. Employer rules in a corporation are also examples of private law. For example, an employer rule that managers cannot have affairs with their direct reports is an example of private law, one that is common in corporations. Private laws are valid so long as they do not infringe any public rights or violate any statutory protections.

### 1-2b CRIMINAL VERSUS CIVIL LAW

A violation of a **criminal law** is a wrong against society. A violation of a **civil law** is a wrong against another person or persons. Criminal violations have penalties such as fines and imprisonment. If you drive while intoxicated, you are breaking a criminal law and are subject to a fine, jail term, or license suspension. If you have an accident while driving intoxicated, you commit a civil wrong against anyone you injure. People who are injured as a result of your driving while intoxicated can file a civil suit against you to recover for injuries to their persons and property (cars).

### 1-2c SUBSTANTIVE VERSUS PROCEDURAL LAW

**Substantive laws** are those laws that give rights and responsibilities. **Procedural laws** provide the means for enforcing substantive rights. For example, when employees of Starwood Hotels left their employment and went to work for Hilton, taking Starwood's plans for a new hotel chain with them, they breached their employment contract with Starwood. Starwood had the substantive right to prevent employees from taking proprietary information with them to new employers. Starwood was able to collect damages for breach of contract by bringing suit against both its former employees and Hilton. The laws governing Starwood's suit (how and where the suit is brought) and the trial process are procedural laws. There are also procedural laws for criminal cases, such as grand jury proceedings or arraignments and preliminary hearings.

### 1-2d COMMON VERSUS STATUTORY LAW

The term **common law** has been in existence since 1066, when the Normans conquered England and William the Conqueror sought one common set of laws governing a then-divided England. The judges in each locality developed a body of law common to all localities throughout the country that could be used to settle disputes. They consulted their fellow judges before making decisions. This principle of following other decisions is referred to as *stare decisis*, meaning "let the decision stand" (see p. 55 and Chapter 3). As a process of legal reasoning, it is still followed today. The courts use the judicial decisions of the past in making their current decisions to provide for consistency.

As much of an improvement as it was, the common law was still just uncodified law. Because of increased trade, population, and complexities, the common law needed to be supplemented. As a result, **statutory law** (also known as codified law), which is passed by some governmental body and written in some form, was created.

Today, both common law and statutory law exist in the United States. Some of our common law consists of principles from the original English common law. For

example, how we own and pass title to real property are two areas of law largely developed from and still controlled by English common law. Our statutory law varies throughout our nation because of the cultural heritages of various regions. For example, the southwestern states have marital property rights statutes—often referred to as community property laws—that were influenced by the Spanish legal system implemented in Mexico. Louisiana’s contract laws are based on French principles because of the early French settlements there.

### 1-2e LAW VERSUS EQUITY

**Equity** is a body of law that attempts to do justice when the law does not provide a remedy, when the remedy is not enough, or when the application of the law is terribly unfair. Equity courts originated in England and were given more latitude to get to the heart of a dispute. Over time, they developed remedies not available under common law. Common law, for example, permitted only the recovery of monetary damages. Courts of equity could issue orders, known as **injunctions**, prohibiting certain conduct. Equitable remedies have been gradually combined with legal remedies so that now parties can request that one court determine which remedies are available and appropriate in their case.

For example, in suits for injunctions, the copyright infringement cases that appear later in this chapter, the recording and motion picture industries asked the individuals to stop their unauthorized copying of movies and songs. The record companies, movie producers, and artists could never be compensated fully with just money for these forms of infringement because the infringement was ongoing as long as the technology was available.

## 1-3 Purposes of Law

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### 1-3a KEEPING ORDER

Knowing that we face costs or a penalty for violating a law, we tend to follow it, a habit that keeps society orderly. Most towns and cities require permits for parades and demonstrations so that law enforcement officials can plan to cover the event for crowd control purposes. Laws that require deeds to be recorded allow us to keep track of who owns what so that we do not have feuds and other less civilized ways of settling land ownership disputes that were part of our early history.

Federal legislation that targets terrorist activities is an example of a series of laws that maintain order and safety in the United States. The USA PATRIOT Act imposes reporting requirements for banks and people who handle large-dollar transactions in order to monitor the flow of funds into the United States (see Chapters 6 and 7). The purpose of the act was to provide the means to curb terrorist activities through early detection of plots and the control of funds used for terrorist activities.

### 1-3b INFLUENCING CONDUCT

Laws also influence the conduct of society’s members. For example, advertising content and media are controlled at both the state and federal levels. Federal laws prohibit television ads for hard liquor. Federal laws also provide protections for companies whose products are misrepresented in competitors’ comparison ads. These laws have changed the way businesses advertise.

**1-3c HONORING EXPECTATIONS**

Businesses commit resources, people, and time with the expectation that the contracts for those commitments will be honored and enforced. You agree to move to a different city because a company has signed an employment agreement with you. Laws require the employer to honor that agreement to protect you. Knowing that we have these protections through the law allows us to trust, contract, and invest with confidence.

**1-3d PROMOTING EQUALITY**

Laws have been used to achieve equality. For example, the equal opportunity employment acts (see Chapter 19) were passed to bring equality to the job market. The social welfare programs of state and federal governments were created to further the cause of economic justice. The antitrust laws attempt to encourage a level playing field for business competition.

**1-3e LAW AS THE GREAT COMPROMISER**

A final and very important purpose of law is to act as the great compromiser. Law serves to mesh different views into one united view so that all parties are at least partially satisfied. When disputes occur, the courts use laws to resolve two opposing views. In the relationship between labor and management, the law serves as the mediator (see Chapter 18).

**1-4 Characteristics of Law****CYBERLAW****1-4a FLEXIBILITY**

As society changes, the law must change with it. As the United States evolves toward a technological and information-based society, still more areas of law will be created and developed. The fax machine and the Internet have resulted in legislation that allows transmitted and electronic signatures to have the same force and effect as signatures on paper (see Chapter 10). Downloading high-quality music and movies via the Internet meant new issues of copyright protection and infringement. New legislation covers technology issues such as identity theft, computer fraud, and spamming. The law had to adapt to technology that resulted in new problems and crimes.

**1-4b CONSISTENCY**

Although the law must be flexible, it still must be predictable. Law cannot change so suddenly that parties cannot rely on its existence or protection. Being able to predict the outcome allows us to rely on a contract. Businesses make long-term plans because they know that contract law will remain consistent and give them the rights and remedies on which they relied in their planning.

**1-4c Pervasiveness**

The law must be pervasive and cover all necessary areas, but at the same time, it cannot infringe individual freedoms or become so complex that it is difficult to enforce. For example, laws cover the formation, operation, and dissolution of corporations. Laws also cover shareholder rights. Corporations have great flexibility in management, so long as they stay within the legal boundaries.

In the following two cases, the courts struggle as they try to honor the law's purposes of keeping order and honoring expectations while also grappling with the unique issues that modern technology raises. The principle of *stare decisis* is at work in these cases (see Chapter 3). *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.* (Case 1.1) is briefed in Exhibit 1.1. A **brief** is a tool used to help summarize a case and focus on its facts and the key points of the court's decision. *Viacom International, Inc. v. YouTube, Inc.* (Case 1.2) provides the answer for the "Consider..." problem posed at the beginning of the chapter.

## CYBERLAW

CASE  
1.1

*Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*  
545 U.S. 913 (2005)

## Copyright Infringement? Really, It's Just a Little Peer-to-Peer File Sharing

### FACTS

Grokster, Ltd., and StreamCast Networks, Inc. (respondents/defendants) distribute free software products that allow computer users to share electronic files through peer-to-peer networks. Universities, government agencies, corporations, and libraries use this technology.

Grokster and StreamCast do not know when particular files are copied. However, MGM had a statistician do a systematic search of electronic files, and his study showed that nearly 90 percent of the files available for download on the FastTrack system were copyrighted works. Per the Court's opinion, "the probable scope of copyright infringement is staggering."

After Napster was sued by copyright holders for facilitation of copyright infringement, *A&M Records, Inc. v. Napster, Inc.*, 114 F. Supp. 2d 896 (N.D. Cal. 2000), *aff'd in part, rev'd in part*, 239 F.3d 1004 (C.A.9 2001), StreamCast gave away a software program known as OpenNap, designed as compatible with the Napster program and open to Napster users for downloading files from other Napster and OpenNap users' computers. The OpenNap program was engineered "to leverage Napster's 50 million user base." Grokster and StreamCast received no revenue from users, who obtained the software itself for nothing.

The District Court held that those who used the Grokster and Morpheus software to download copyrighted media files directly infringed MGM's copyrights, but granted summary judgment in favor of Grokster and StreamCast as to any liability arising from distribution of the then current versions of their software. The Court of Appeals affirmed. MGM appealed.

### JUDICIAL OPINION

SOUTER, Justice

The question is under what circumstances the distributor of a product capable of both lawful and unlawful use is liable for acts of copyright infringement by third parties using the product.

When a widely shared service or product is used to commit infringement, it may be impossible to enforce rights in the protected work effectively against all direct infringers, the only practical alternative being to go against the distributor of the copying device for secondary liability on a theory of contributory or vicarious infringement.

[T]his Court has dealt with secondary copyright infringement in only one recent case. In *Sony Corp. v. Universal City Studios*, 464 U.S., at 434, this Court addressed a claim that secondary liability for infringement can arise from the very distribution of a commercial product.

On those facts, with no evidence of stated or indicated intent to promote infringing uses, the only conceivable basis for imposing liability was on a theory of contributory infringement arising from its sale of VCRs to consumers with knowledge that some would use them to infringe. But because the VCR was "capable of commercially significant noninfringing uses," we held the manufacturer could not be faulted solely on the basis of its distribution. Because the Circuit found the StreamCast and Grokster software capable of substantial lawful use, it concluded on the basis of its reading of *Sony* that neither company could be held liable, since there was no showing that their software, being without any central server, afforded them knowledge of specific unlawful uses.

CONTINUED

This view of *Sony*, however, was error, converting the case from one about liability resting on imputed intent to one about liability on any theory.

Here, the summary judgment record is replete with other evidence that Grokster and StreamCast, unlike the manufacturer and distributor in *Sony*, acted with a purpose to cause copyright violations by use of software suitable for illegal use.

[N]either company attempted to develop filtering tools or other mechanisms to diminish the infringing activity using their software. This evidence underscores Grokster's and StreamCast's intentional facilitation of their users' infringement.

StreamCast and Grokster make money by selling advertising space, by directing ads to the screens of computers employing their software. As the record shows, the more the software is used, the more ads are sent out and the greater the advertising revenue becomes. The unlawful objective is unmistakable.

One who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties.

The judgment of the Court of Appeals is vacated, and the case is remanded for further proceedings consistent with this opinion.

### CASE QUESTIONS

1. What is the difference between Sony's Betamax and Grokster's software program?
2. What additional grounds for imposing vicarious liability for copyright infringement can be used beyond "other lawful means of use"?
3. List the critical facts that tipped the court's decision against Grokster.



### Business Planning Tip

Failure to anticipate technological changes results in significant revenue losses under contracts for copyrighted works or patented products. For example, many actors, writers, and others involved with television shows of the 1950s and 1960s do not enjoy the royalties from their shows, which run in what seems to be perpetual syndication on networks such as TV Land and Nick at Nite that feature only television shows of other generations. Those involved in the production of these shows did not foresee what technology would permit. Walt Disney and Universal did not anticipate the video tape recorder and its capability.

Technology clauses in royalty agreements for patents and copyrights that cover any future means of distribution, whether by wire, sound, or satellite, provide an open-ended agreement for royalty coverage from evolving technology distributions and uses.

### EXHIBIT 1.1 Sample Case Brief

Name of case:	<i>Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.</i>
Court:	U.S. Supreme Court
Citation:	545 U.S. 913 (2005)
Parties and their roles:	Metro-Goldwyn-Mayer Studios, Inc. (MGM/petitioner and plaintiff); Grokster and StreamCast Networks, Inc. (respondents/defendants)
Facts:	Grokster distributes free software that allows computer users to share electronic files. MGM found that 90 percent of the files shared were of copyrighted material. Grokster does not earn revenues but MGM sued for vicarious copyright infringement through their programs.
Issues:	Does Grokster's software and its use by its customers infringe on MGM's copyright?
Lower court decision:	The District Court granted summary judgment for Grokster. The Court of Appeals affirmed.
Decision:	Grokster was liable to MGM for copyright infringement.
Reasoning:	Grokster's program had no purposes other than facilitating infringement.



**CASE  
1.2***Viacom International, Inc. v. YouTube, Inc.*  
718 F. Supp. 2d 514, 95 U.S.P.Q.2d 1766 (2010)**If I Find It on YouTube, It's Not Mine or Fine****FACTS**

YouTube, owned by Google (defendants), operates a website at [www.youtube.com](http://www.youtube.com) where users may upload video files free of charge. Uploaded files are copied and formatted by YouTube's computer systems and can then be viewed on YouTube. Presently, over 24 hours of new video-viewing time is uploaded to the YouTube website every minute.

The presence of copyright-infringing material on YouTube's website was attractive to users, and their increased usage resulted in more income for YouTube from advertisements. Viacom (and other television and production companies) (plaintiffs) claim that tens of thousands of videos on YouTube were taken unlawfully from Viacom's copyrighted works without authorization and that YouTube either knew or was aware of facts or circumstances that indicated infringement was afoot.

YouTube had an agent designated to receive notices from copyright owners about YouTube infringements. When the agent received infringement notices, the infringing material was removed quickly. YouTube has removed all the clips that Viacom and the others claim infringed their copyrights.

Viacom brought suit to require YouTube to actively search for infringing clips and remove them. Viacom argues that YouTube has liability for infringement because it is aware of infringing uses of its site and that it should not have to notify YouTube of all infringements.

YouTube moved for summary judgment on the grounds that the Digital Millennium Copyright Act's (DMCA) had a safe harbor that protected it against direct and secondary infringement claims.

**JUDICIAL OPINION**

STANTON, District Judge

Due to the ease with which digital works can be copied and distributed worldwide virtually instantaneously, copyright owners will hesitate to make their works readily available on the Internet without reasonable assurance that they will be protected against massive piracy.

At the same time, without clarification of their liability, service providers may hesitate to make the necessary investment in the expansion of the speed and capacity of the Internet. By limiting the liability of service providers,

the DMCA ensures that the efficiency of the Internet will continue to improve and that the variety and quality of services on the Internet will continue to expand.

Subsection 512 (c)(1)(A)(ii) of DMCA can best be described as a "red flag" test. A service provider need not monitor its service or affirmatively seek facts indicating infringing activity. However, if the service provider becomes aware of a "red flag" from which infringing activity is apparent, it will lose the limitation of liability if it takes no action.

A service provider wishing to benefit from the limitation on liability under subsection (c) must "take down" or disable access to infringing material residing on its system or network of which it has actual knowledge or that meets the "red flag" test, even if the copyright owner or its agent does not notify it of a claimed infringement. For their part, copyright owners are not obligated to give notification of claimed infringement in order to enforce their rights. The common-sense result of this "red flag" test is that a provider proceeding in the face of such a red flag must do so without the benefit of a safe harbor.

The important intended objective of this standard is to exclude sophisticated "pirate" directories, which refer Internet users to other selected Internet sites where pirate software, books, movies, and music can be downloaded or transmitted from the safe harbor. Such pirate directories refer Internet users to sites that are obviously infringing because they typically use words such as "pirate," "bootleg," or slang terms in their uniform resource locator (URL) and header information to make their illegal purpose obvious to the pirate directories and other Internet users.

*Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd.*, 545 U.S. 913 (2005) and its progeny furnish core principles heavily relied on by plaintiffs and their supporting *amici* [friends of the court], [but] have little application here. *Grokster* addressed the more general law of contributory liability for copyright infringement, and its application to the particular subset of service providers protected by the DMCA is strained.

The *Grokster* model does not comport with that of a service provider who furnishes a platform on which its users post and access all sorts of materials as they wish, while the provider is unaware of its content, but identifies an agent to receive complaints of infringement, and

CONTINUED