
A FRAMEWORK FOR ASSESSING THE NEED FOR LEGAL READINESS IN SMALL AND ENTREPRENEURIAL FIRMS

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ABSTRACT

A great deal of attention is being given to legal problems in organizations and their efforts toward legal compliance. Most of the attention has been upon larger firms. This paper seeks to provide a framework under which both large and smaller entrepreneurial firms can assess their legal readiness. Industrial Organization theory suggests that the firm's profitability and growth prospects depend upon the external environment confronting the firm and the firm's actions and reactions to these factors. Research on the external environment of small firms has focused on economic, socio-cultural, demographic, and technological elements in small firms. However, legal issues have not been given extensive consideration. Clearly, legal issues can present substantial threats or opportunities to the firm. Surprisingly, in spite of recent recognition that legal issues can be particularly important to both large and small firms, the literature does not present a clear perspective of the legal factors that may be significant specifically to small business owners. We propose a framework for evaluating the potential impact of legal issues on a small firm. This discussion serves as the basis for a broader discussion of how political and legal elements may impact the small firm.

INTRODUCTION

Business and society in general, is placing a great deal of emphasis upon both legal compliance and legal problems in organizations. While large

organizations may have a sophisticated approach to legal compliance, or "legal readiness", many smaller and entrepreneurial organizations generally are less prepared in this arena.

The influence of the external environment on a firm's actions can be conceptualized using the Industrial Organization theory of the firm (Hoskisson, et. al., 1999). This conceptualization argues that an organization's profitability and growth prospects depend upon the environmental factors it faces (Schendel, 1994). Business executives are urged to scan the environment in an effort to identify opportunities and threats that may affect their companies as part of their efforts to plan for the future and to position their organizations to compete (Elenkov, 1997; Goll & Rasheed, 1997). Students of strategic management are taught the benefits of scanning the external business environment in order to identify trends in society (for example, see Thompson and Strickland, 2001; Hitt, et. al., 2001; David, 2000). These factors or elements of the external environment are commonly grouped into the Economic, Socio-Cultural, Demographic, Global, Technological, and Political-Legal elements (Hitt, et. al. 2001).

The extant research on small firms and entrepreneurs has argued that small business owners and entrepreneurs also must be thoroughly aware of their external environment (for example, see Johnson and Kuehne, 1987, Smeltzer, Fann & Nikolaisen, 1988; Specht, 1987; Robinson, et. al. 1998). Generally, most research on the external environment of small firms has focused on economic, socio-cultural, demographic, and technological elements where small firms are concerned. However, legal issues have not been given extensive consideration (Robinson, Jackson, Franklin & Hensley, 1998). Clearly, legal issues can present substantial threats or opportunities to the firm. We define legal issues as including "any laws or regulations enacted by federal, state, or local government" as well as typical legal and legal compliance practices of business owners.

Most of the literature concerning legal threats and opportunities has been studied from the perspective of the large firms that dominate the U.S. economy. (For example, see studies by Hambrick, 1981 or Daft, Sormunen, and Parks, 1984.) Studies that identify legal issues impacting big business are not necessarily relevant to the legal concerns and issues facing the small

business owner. We still do not have a clear understanding of the identity of legal factors that may be significant to small business owners. The legal issues important to big business may be of less relevance or of minor importance to small business owners.

Internal legal practices of businesses and the external laws and regulations affecting those businesses can impact small business performance (Robinson, Jackson, Franklin & Hensley, 1998). If the small business owner, with fewer human and financial resources than those available to big corporations, can identify critical legal factors for the benefit of the small firm, knowledge of these legal issues can improve the legal environment. The legal concerns unique to small business owners and the identification of those issues may be developed through a consistent inquiry into the practices of family-owned, and other small businesses.

Thus, the purpose of this paper will be to demonstrate need for additional research relating to the legal issues in the external environment of the smaller firm. Using an observational research method, we later hope to show that a few types of emerging legal issues can seriously impact the small firm. These findings will then serve as the basis for a broader discussion of how political and legal elements can impact the small firm.

LITERATURE REVIEW

In this paper the authors have artificially restricted the broad definition of legal issues to narrow the focus of the study and exclude less salient legal issues. In general, legal issues are defined as including "any laws or regulations enacted by federal, state, or local government" as well as typical legal and legal compliance practices of business owners. The specific definition of legal issues, for purposes of this paper, will include the following legal practices: use of contracts, decision-making constraints, human resource law, use of legal advisors, and other factors discussed here.

When examining the relevant literature only a limited number of helpful articles relating to small business practices was found. Without a foundation in the literature, it is difficult to develop a theory or formulate a checklist of essential legal issues affecting the small firm.

There is, however, no shortage of articles giving prescriptive advice on particular legal issues in the literature. Numerous articles advise a small business owner about how to handle everything from AIDS in the workplace (Franklin & Gresham, 1992; Hoffman & Clinebell, 2000) to sexual harassment (Robinson, et. al. 1998) and taxes. Compliance with tax regulations, environmental regulations, employment regulations, accessibility regulations, industrial and safety regulations, and the impact of federal laws on business are just a few of the myriad of legal topics addressed by the literature. When examining industry-specific topics, the review of specialized standards for performance and operations, quality and control, and industry-wide guidelines may also be determinative of how a firm channels its legal resources. Other opportunities for detailed review of legal concerns include the ownership of land and facilities and the impact of the locality on zoning and planning regulations that affect the business.

Beyond prescriptive advice however, we were surprised that the extant literature has simply not developed a useful profile of the legal issues that may be critical to the unique position of small business owners. The small business literature is lacking research manuscripts based upon theoretical underpinnings. Instead, ad hoc articles on various legal topics dominate the small business literature complimented with "legal advice" articles on specific legal issues.

SCANNING THE ENVIRONMENT

The extant literature related to scanning the environment is well known to readers of the small business management, entrepreneurship, new venture creation, organizational theory, or strategic management literature. Thus, this section will not elaborate the scores of articles that describe this critical activity. This review will focus on two recent directions in the literature. First, we will highlight the efforts of small business owners to identify significant political and legal issues in their industry. Secondly, we will focus on the implications of failing to do so as noted in recent articles by West and DeCastro, 2001.

Perhaps the state of our understanding of legal issues and small businesses can be surmised by reviewing a recent special issue in *Entrepreneurship: Theory & Practice* (Katz, Aldrich, Welbourne & Williams, 2000). The entire issue was devoted to "Human Resource Management" (HRM) issues and small and medium-sized businesses. Surprisingly, none of the articles emphasized legal issues related to small firms. The absence of legal issues is shocking since the human resource function is responsible for so many legal issues related to the personnel in a firm, such as fair hiring, Aids/HIV, wrongful discrimination, labor relations, affirmative action, OSHA, workers compensation, sexual harassment, etc. (Carrell, Elbert & Hatfield, 2000). Ironically, the guest editors noted that "very little serious academic work on human resource management was carried out within smaller firms" (Katz, et. al., 2000, p. 7). Apparently, this lack of serious academic work with regard to legal issues in small firms (at least at it relates to HRM) was a problem in their own special issue. Not one of the seven articles in the special issue addressed legal issues related to HRM in a serious or extensive manner.

Legal issues are rarely discussed in small business studies (See, for example, Smeltzer, L. R., Fann, G. L. & Nikolaisen ; Fann and Smeltzer, 1989; Lang, Calatone, and Gudmundson (1997) or Beal (2000). For instance, the studies by Fann and Smeltzer (1989) and Land, Calatone, and Gudmundson (1997) conclude that it is important for small business managers to recognize the importance of external environment issues with regard to "customers and competitors". The Fann and Smeltzer (1989) article focused on competitors while the Lang, Calatone, and Gudmundson (1997) study emphasized environmental threats and opportunities generally. Lang, et. al. study small firms found positive relationships between perceived threats and information seeking and between perceived opportunities and information seeking. Yet, there was a negative relationship between perceived threats and perceived opportunities. Thus, their study suggests the possibility of selective perception among small firm managers. Beal's (2000) study concluded that political conditions do not appear to be critical to either the mature or the growth stages of industry development. The fact that these

studies neglected the area of legal issues may not be an indication that legal issues are not important but perhaps just indicate a focus upon other issues.

Review of the current literature leads to only two journal articles that specifically emphasize the importance of political issues (cited in Sawyerr, 1993; Sawyerr, 1994; Sawyerr, Edbrahimi, and Thibodeaux, 2000). However, the sample of small firms in the first study was gathered from Nigerian firms. Given the political upheaval in Nigeria, the political elements of the general environment are obviously important. However, the situations in the U.S. and Nigeria are arguably very different. In the second article, Smeltzer and Fann (1988) conclude that small business owners do not value the advice of accountants, bankers, and lawyers. Their finding is curious given the findings of Chrisman and McMullan (2000) that small firms benefit from the advice of outsiders such as SBDC consultants. Chrisman and McMullan suggest that small business owners do value the advice of friends and family as well as their own ability to read about trends and issues in magazines.

Sonesy, Baugh, Newton and Gulbro (1997) conducted the only study of specifically emphasizing legal issues in small businesses. Their phone survey of 27 small businesses in a single state conducted in 1996 revealed that only one-third of the firms had made changes to comply with the Americans with Disabilities Act, Civil Rights Act of 1991, or Family and Medical Leave Act. This finding is particularly disturbing because each of these laws had been passed 6, 3, and 5 years, respectively, before the survey was completed. The findings give cause for alarm about the state of readiness among small firms with regard to emerging legal issues, such as environmental hazards, limited liability corporations, detailed employee record keeping, or arbitration clauses.

DISCUSSION

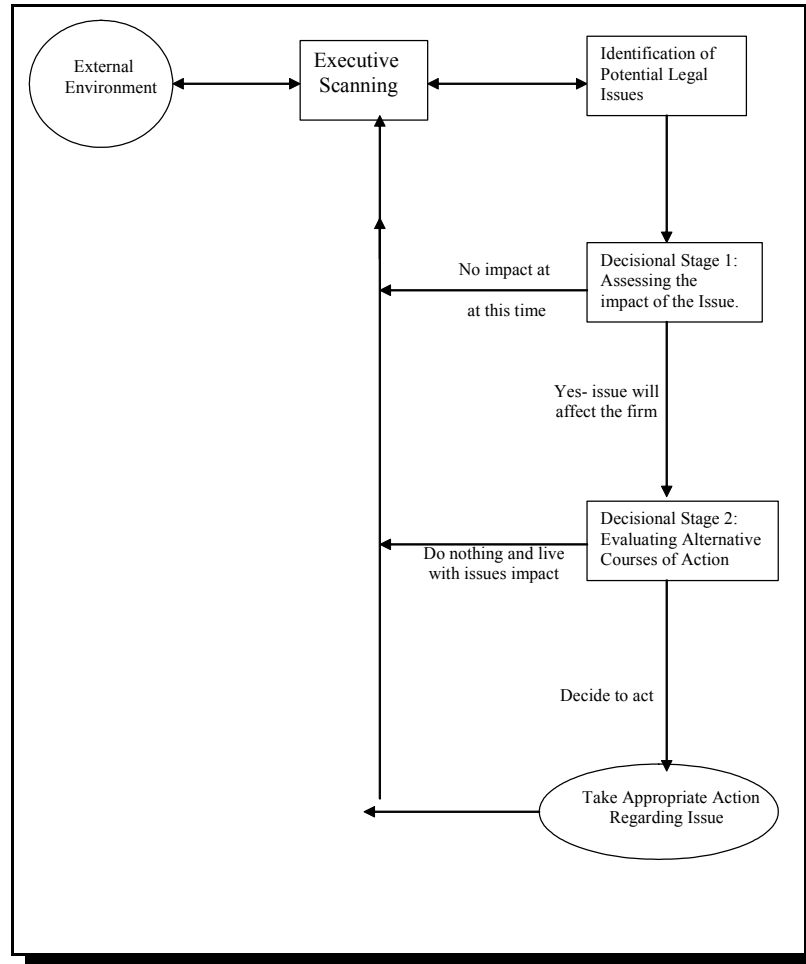
The identification of the legal issues that were discovered as part of our research process suggest that small firms must be cognizant of these issues just as they would economic, socio-cultural, or technological issues. The ramifications of not knowing this information are extremely important.

According to research by Lang, Calantone, and Gudmundson (1997), their study of small firms found positive relationships between perceived threats and information seeking and between perceived opportunities and information seeking. However, they identified a negative relationship between perceived threats and perceived opportunities, which raised the possibility of selective perception among small firm managers. This finding suggests that small firms may only seek out information in the normal course of managing their firm. Thus, new legal issues or political changes may not be evaluated unless they immediately affect the firm. Their research suggests that small business owners do not casually survey their legal environment in search of potentially important issues. They only survey their legal environment if they have a priori knowledge of the issue's potential importance. Beal's study (2000) suggests that small business owners fail to scan the environment simply because they are "constrained by their involvement with daily operations" (Beal, 2000, p. 44).

Such a situation is ripe for disaster. According to West and DeCastro (2001), the failure to correctly identify legal, regulatory, and political elements of the external environment may represent a resource weakness and distinctive inadequacy. The small business owner may fall into a trap by believing that he knows the relevant legal and regulatory issues that impact his or her firm. However, as prior research suggests (Franklin & Gresham, 1992; Robinson, et. al. 1998), small firms often do not have a grasp on these types of issues. Thus, we would suggest that the following steps be taken, at a minimum, to ensure that the firm is adequately positioned to meet the legal issues that may impact it (See Figure 1).

The proposed model suggests that the external environment is a significant factor for small as well as large businesses. Further, as discussed in this article, there is strong support for the executive scanning activity of the organizational leadership. Part of that continuous scanning is to react to critical issues thrown at the organization from the external environment. Our model suggests that small business leaders adopt a general decision-making approach to handling the issues surrounding law and legal compliance.

Figure 1



Step 1: *Identification of potential legal issues.* Further research can identify the broad categories which will likely include anti-discrimination laws, safety and health laws, pay laws, tax laws, incorporation laws, contract laws, and others. This area needs additional research and a fleshing out of the relevant categories.

Step 2: *Decisional Stage 1* - Assessing the impact of the future. If there is no impact at the immediate time then the leader continues executive scanning. However, if there is impact that is immediate or significant future impact can be recognized now the leader moves to the next step. For instance, a small employer may feel that they need no immediate reaction to the Civil Rights Act Amendment of 1991. However, many larger employers found that it was important to prepare for possible discrimination complaints in advance of having a complaint. Small business leaders need to be able to assess both the immediate and the long-term issues as they arise. The literature needs to help in this area.

Step 3: *Decisional Stage 2* - Evaluating alternative courses of action. The possibilities will include deciding upon the appropriate reaction or living with the impact of the legal issues on the organization. Small business owners and leaders need additional information to help make their choices at this stage.

Step 4: *Take appropriate action*. At each step the small business leader is continuing to scan the external environment. For instance, as cited above, there was a flurry of very significant employment laws at the beginning of the prior decade. The Americans with Disabilities Act was passed in 1990 and the Civil Rights Act Amendment was passed in 1991. Leaders cannot afford to focus exclusively on one legal area without maintaining the scanning since yet another critical issue may quickly emerge. Small business owners and leaders need help in scanning the relevant legal environment.

SUMMARY

Small firms are acknowledged not to have the resources necessary to cope with potential errors relative to their larger competitors (Palmer, Wright & Powers, 2001). We believe the legal issues identified in this study are only the "tip of the ice berg" representing the legal, political, and regulatory environment.

We believe this study emphasizes the need to stay abreast of current issues in the legal, political, and regulatory environment of the small firm.

In fact, we propose the discussed model as a starting point in improving the legal readiness of the small business leader.

As potential consultants to small firms or as faculty advisors to consulting teams, Small Business Institute Directors are in a unique position to influence small firms. Clearly, you can only suggest what should be done. However, many owners of these small firms will readily listen to your advice. Perhaps the summary comments by Barney, Frances, and Ringleb (1992) best summarize the perspective that should be taken.

Indeed, virtually every introductory organizational theory and management author cites the importance of the legal environment facing organizations. However, much organizational research remains relatively naive about the organizational implications of the law. Several bodies of law seem likely to affect and constrain organizational actions, including tax laws, laws about equal employment opportunity, employee health and safety, product liability law, antitrust law, and the criminal law discussed in this article. A significant challenge facing organizational scholars is to become sufficiently familiar with these bodies of law that they can anticipate their implications for the organizational phenomena under study (Barney, Frances & Ringleb, 1992, 345). Clearly, their advice extends to SBI Directors in their capacity as advisors to student groups and consultants to small firms.

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