The Legal Environment of Business

A Policy Perspective

Douglas K. Glasgow

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Texas A & M University

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CHAPTER 1

DEFINING AND ANALYZING THE LEGAL ENVIRONMENT OF BUSINESS

The law plays two major roles in the business world: dispute resolution and regulation. In its **dispute resolution role**, it facilitates mutually beneficial exchanges through the enforcement of contracts and the recognition of private property rights. This dispute resolution role of the law is the subject of a more narrowly defined business law class. In its **regulatory role** it directs and standardizes activities that would otherwise be considered purely private interactions of individuals. Its regulatory role is typically justified on the ground that society has some stake in the outcome of the regulated activity and that the well-being of society can be improved through government involvement. In essence, the government becomes an active third party by regulating the activity and is a potent force in the legal environment of business. We define the legal environment of business as the system of laws regulations, and procedures that interact with the economic system in an attempt to maximize the well-being of society. The legal environment of business course and this textbook explores the many facets of this arrangement including how government regulations affect businesses. The goal of this textbook is to describe the very broad set of government regulations that affect business behavior and to analyze the impact of those regulations on business organizations and society.

Like American society, the legal environment of business is constantly changing. This is due in large part to the American political process that periodically, and sometimes alternatively, selects leaders who propose radical changes in regulatory policy. The fact that today's law may be repealed or amended by the time you become responsible decision makers in the business world suggests that learning precise rules of law, although an important intellectual and educational experience, is of little practical value. On the other hand, learning to think critically about the substance of public policies embedded in the legal environment of business has tremendous practical value because it provides a basis for understanding and following changes in regulations that affect businesses. Thus, this textbook has the dual purposes of describing the laws and regulations as well as developing an analytical framework for public policy analysis of government regulations. The framework reveals a substantial emphasis on the role that economic, political, and social forces play in shaping the regulatory environment of business.

Chapter 1 serves as an introduction to the legal environment of business. The first section defines the law and the legal environment of business by considering the societal role of the law in regulating or controlling business behavior. It also considers the relationship between the law and other sources of social control such as ethical considerations and market forces. The second section defines the legal environment of business as the regulated market system, which is a compromise between the extremes of unfettered markets and complete government control. The materials focus on theoretical justifications for government regulations that form the basis for the regulated market system. The third section presents the principles of public policy analysis that will be applied throughout this textbook.

A. Law, Society, and the Legal Environment of Business

"Law" is a very broad concept that eludes a precise definition. First, lets consider the definitions offered by Black's Law Dictionary:[1]

1. *Law, in its generic sense, is a body of rules of action or conduct prescribed by controlling authority, and having binding legal force.*

2. *That which must be obeyed and followed by citizens subject to sanctions or legal consequences is a law.*

Justice Oliver Wendell Holmes offered the following definition: "Law is a statement of the circumstances in which the public force will be brought to bear through courts."[2] Professor H. E. Willis, a legal commentator in the 1920's, concentrated on the behavioral modification role of the law when he stated that the law was "a scheme for controlling the conduct of people. . . . Law is a scheme of social control, for the protection of social interests, by

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[1] Black's Law Dictionary, 5th ed. (St. Paul: West Publishing Co., 1979), p. 795.

[2] *American Bananas Company v. United Fruit Company*, 213 U.S. 347, 356 (1902).

means of capacities of influence, backed and sanctioned by the power of the state."[3] This latter role, through which society controls or regulates business behavior, is the focus of the legal environment of business.

The legal environment of business course is about how society, through government actions, attempts to improve the well-being of its citizens by helping to allocate society's limited resources in the most efficient manner possible. This objective, although it may not be visible to the untrained eye, is the purpose of the complex system of laws and regulations that shape the legal environment of business. This textbook approaches the legal environment of business from a public policy perspective. The most enduring way to learn and understand the legal environment of business is to understand why government regulation is necessary to improve the well-being of society, however you may define "well-being." Public policy analysis is concerned with the issue of how best to create the environment in which society can meet its stated goals of increasing well-being.

Nearly everyone has their own idea of how society should measure its well-being. A parent may measure well-being by examining schools, while environmentalists may use the ecosystem as their gauge. An economist may measure well-being by Gross National Product which measures the dollar value of output of society. Still others may use mortality rates, crime rates, suicide rates, income distribution, hours of leisure, or net immigration. It would be ideal if society could satisfy everyone, but unfortunately, all societies are bound by the amount of resources available to produce well-being. Resources may be increased over time through discovery or enhancements in technology, but they are relatively fixed at any point in time. Of course, this does not mean that society cannot increase its well-being, but it does limit how well-being can be increased. Society must choose how to employ the available limited resources in order to maximize well-being. If limited resources are being used inefficiently, well-being can be increased by improving the manner in which resources are being used to produce the necessary components of well-being whatever they may be.

The decision to change the allocation of resources often involves difficult choices, or tradeoffs. For example, it would be desirable to improve health care, but how would you feel about it if it meant that more people would go hungry? Would the increase in health care at the expense of hungry people necessarily translate into an increase in the well-being of society? Since intelligent people will disagree on the answer to this question, our political system is often called upon to make the difficult choices concerning which components of well-being should be increased or decreased. These political choices define the legal

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[3] H.E. Willis, Introduction to Anglo-American Law (Indiana University Studies, Vol. XIII, No. 69, 1926), pp. 10-11.

environment of business: the system of laws, regulations, and procedures that interact with the economic system in an attempt to maximize the well-being of society.

Laws and regulations are not the only means by which business responds to the needs of society. Business decision makers are often influenced by their own response to market forces and personal ethical standards to act in society's interest. These two considerations are important aspects of the legal environment of business and deserve further consideration.

1. Market Forces

Businesses that disobey the law may be ordered by the government to cease certain activities that are in violation of the law, they may be fined, and business executives may even serve jail time. But obeying the law does not insure the success of a business. Indeed, to a large extent, success depends of the ability of a business to adapt to economic or **market forces**. The most important of these forces are competition and profits.

Competition is the struggle to obtain that which is limited in quantity to the extent that everyone cannot have as much as he or she desires. As a result, people must compete in order to get what others also want whether it is customers, income, assets, or resources, to name a few. In fact, can you think of anything that you enjoy for which you do not have to compete? Consider the following propositions.

Factory owners must compete with each other for the most productive workers. This competition acts as a restraint on the behavior of the owner. For instance, if the owner invests very little in worker safety equipment compared with competitors, the owner will have to pay higher wages to workers to compensate them for their greater risk of injury. The owner's production costs may be higher or lower than competitors' depending upon the tradeoff between worker safety equipment and wages. If production costs are higher than those of competitors, the owner must adjust the combination of worker safety and wages to lower costs because of price competition at the product level. If the combination of worker safety equipment and wages leads to comparatively lower production costs, then competitors will be forced to alter their combination of equipment and wages in order to compete with the product prices of the factory owner. Hence, competition from many sources restricts the freedom of businesses much as does the legal environment.

The bottom line for the majority of businesses is that they must, at least in the long run, be profitable. A business may want to make an automobile that is 100 percent safe in any accident but unless buyers are willing to pay the price for such an automobile, it cannot be produced. Businesses must be successful in selecting the combination of price and qualities that consumers want which will produce profits or be replaced by a business that is better at such selection.

2. Ethical Considerations

Ethical issues are the moral dilemmas that business men and women face when choosing a course of action. It is not as simple as choosing between a course of action that is morally right and one that is morally wrong because often the choice depends upon one's point of view. For instance, many members of society believe that corporations should assume a greater leadership role in protecting the environment. In order to do so, however, corporations must expend considerable resources on waste disposal or modification of their products or their production processes. But, is it morally right for directors of corporations to spend profits belonging to their shareholders without their consent? Would it be fairer to give profits to the shareholders and let them contribute to protecting the environment directly, rather than have the directors make the decision for them? What if the competitors of an environmentally concerned corporation were not so concerned with the environment and ran the concerned corporation out of business because of lower costs and lower prices? What of the workers who would lose their jobs? What of the consumers who would have to pay higher prices for life sustaining products because of environmental concerns? Unfortunately, a discussion of ethical issues cannot provide answers or even guidance in solving these dilemmas. In fact, the more one discusses ethics, the less clear the answers become.

Ethics should not be confused with the law. While it is clearly lawful for companies to sell products that injure consumers such as cigarettes, the ethical issues are more controversial. On one hand it may be unethical not to let consumers have the freedom to decide for themselves what is best for them. On the other hand, it may be unethical to expose consumers to the dangers to which cigarettes have been scientifically linked. We will endeavor to identify ethical issues that face modern business men and women in order to prepare you to face them in the future.

B. Allocation of Resources by Society

Societies are groups of people cooperating with each other in order to increase their own well-being. The first societies were probably formed when it was discovered that one could spend less time on hunting and defending oneself when working with a group than when working alone. Later, it was discovered that one could increase his or her own well-being by specializing in certain tasks and trading with others for everything else they needed.

This cooperation led to the formation of larger and larger societies and eventually to governments whose purpose was to maximize the well-being of its members.

The American legal environment of business is, at least in theory, a plan or blueprint to maximize the well-being of the people of the United States. It works in conjunction with the economic system and moral and ethical codes to produce the greatest well-being that our limited resources can produce.

Resources	X	Legal Environment Economic System Moral and Ethical Values	=	Well Being

Figure 1

The interaction between these elements can best be described by use of the diagram in Figure 1. Resources are not limited to the traditional notions of physical resources such as minerals, fossil fuels, agricultural land, etc., but include physical attributes such as clean air and water, and scenic beauty as well as less measurable qualities such as knowledge, artistic talent, and time. Indeed, time is a resource that every living member of society has, if nothing else. Although resources can be increased or decreased over time, at any point in time they are relatively fixed and scarce, that is, society does not have all it wants.

Well-being is difficult to quantify and there is no need to do so here. As mentioned earlier, nearly everyone has their own idea of how to measure well-being, but, for now, we ignore the physical measure of well-being in favor of a general concept. Well-being is, simply put, anything that improves the lives of individuals in society. It includes goods and services whether they are considered luxuries or necessities. It includes clean air and water, scenic beauty, and artistic expression. It includes freedom, security, health, and leisure.

The goal for a society is to transform and allocate resources into well-being in the most efficient way possible, that is, to get the most well-being from any given level of resources. One may ask why clean water as a resource must be transformed by society into clean water as an element of well-being. The answer is society must *preserve* clean water through laws and regulations so that the impetus of competition does not force industry to use the clean water to dispose of waste products.

The transformation and allocation system of resources into elements of well-being in the United States is a combination of laws, voluntary transactions, and moral and ethical values. The combination varies with each resource because each resource has special characteristics. For instance, society does not use the same combination of laws and voluntary transactions to allocate prescription drugs as it does to allocate candy because members of society know far less about the effects of drugs than candy. Furthermore, society may use strict laws to prohibit outrageous behavior such as murder but appeal to ethics and morality to reduce littering.

One of the most difficult and complex concepts to grasp is the interaction between the government and the economic system which is the very heart and soul of the legal environment of business. The combination of law and economics varies widely among societies with corresponding degrees of success in extracting the most well-being out of scarce resources.

It is useful to consider two extreme methods of transforming and allocating resources by society. One extreme method is for the government to own all resources and make all transformation and allocation decisions for members of society. The systems in the Peoples' Republic of China and the former Soviet Union approach this extreme method. The other extreme method is for all resources to be owned by members of society and transformation and allocation decisions are made by individuals trading with each other through voluntary transactions. Hong Kong probably most closely adopts this method.

Both extreme methods have advantages and disadvantages in terms of the efficient use of resources. The challenge is to combine the advantages of both and eliminate the disadvantages of both. The legal environment of business in the United States has evolved as a result of such attempts at combination.

The following two sections discuss the fundamentals of these two extreme systems as well as their advantages and disadvantages. It should be noted that these two systems are far too complex to very specific about the way they operate. The reader is cautioned to think of them in very broad terms. There are mechanisms at work to which entire courses could be devoted. We begin with the ownership and allocation of resources by individuals.

1. Transformation and Allocation of Resources by Markets

Consider the ownership of all resources by members of society. The role of the government, though important, is limited to the provision of public works, national defense, and law and order. Resources in this system are transformed and allocated by the owners of resources trading with each other. Although resources are not owned equally by all members of society, all members own at least one resource: time. A person can choose to exchange some of his or her time with an employer for another resource such as money. Obviously, competing sellers of a resource would seek the highest value attainable from competing buyers of the resource. A system that relies upon voluntary exchanges to transform resources into elements of well-being is referred to as a **market system**.

In a market system, it is the individual who decides which exchanges increase his or her own well-being the most. It is the self interest of each individual that guides his or her to maximize personal well-being through these exchanges.

Society's well-being is maximized by individuals maximizing their own well-being because each exchange involves a voluntary buyer and a voluntary seller. Since the exchanges are voluntary, both parties must be engaging in the exchange to make themselves better off, but at the same time make each other better off. So even though individuals are guided by their own self interest they make others better off through exchange. This point was best made by Adam Smith, the father of economic analysis of the market system, in 1776 in his classic treatise, *An Inquiry Into the Nature and Cause of the Wealth of Nations*. According to Smith a baker in a market system does not bake bread because he or she is benevolent or has the interest of society at heart. The baker bakes bread to earn a profit, and it is this self-interest, or "invisible hand," that causes the baker to do something for others. As a result, consumers are freed from the task of baking their own bread and can use their time in a more efficient manner. The ability of the baker to exchange his bread for more valuable goods is facilitated by the existence of market prices for bread and other goods.

a. The Price System

The market system relies upon the self-interest of individuals to enter into voluntary transactions on mutually agreed upon terms called prices. Both the seller and the buyer dictate prices in the sense that either may reject the prices offered by the other. Obviously, if individuals had to negotiate every price in every transaction, little if any other productive activity could take place. Both participants of most transactions are assisted by the formation, in the market system, of market prices.

Market prices are formed by an aggregate of consumers and an aggregate of producers interacting with each other to coordinate the total amount purchased with the total amount produced. When these two amounts are not the same, there is a change in market prices which induces behavioral changes in both buyers and sellers. These behavioral theories have been transformed by economists into the laws of supply and demand.

The law of demand is a formal expression of a basic human behavioral characteristic that has been demonstrated by behavioral scientists many times. The law of demand states that as the price of a good increases, less is purchased as buyers reduce their purchases of that good and perhaps buy substitute goods. When prices decrease more is purchased as buyers substitute the lower priced goods with relatively higher prices. In fact, we could actually make a chart of the amount that buyers would buy at various prices and if we wanted to know how much buyers would purchase at any particular price we could simply read it from the chart.

This chart, however, would not tell us what the market price would be, because market prices are a result of interaction between buyers *and* sellers. Seller behavior is described by the law of supply which tells us how much sellers will produce at various prices. Unlike the law of demand, however, the law of supply is a positive relationship between prices and the amount produced, that is, as prices increase, sellers produce more. This is because higher prices enable the producers to bid resources away from alternative uses which the producer must be able to do in order to produce more. It is similar to an individual's decision of how many hours to work. An employer may be able to induce an individual to work a certain number of hours for $5.00 per hour but could get the individual to work more hours at $30.00 per hour. This is because the higher wage buys more of the individual's time away from alternative uses of it. In a competitive industry, the employer would have to get a higher price for the product in order to pay a higher wage.

Market prices are a result of the interaction of supply and demand. Prices are constantly adjusting so that the amount that buyers want is exactly equal to the amount sellers are willing to produce. This price is called the equilibrium price. If the amount sellers produce at a particular price is greater than the amount buyers will purchase at that price, then the price will fall. When the price falls, the amount buyers will purchase increases and the amount sellers can produce decreases. Similarly, if the amount sellers are producing is less than the amount buyers want at a particular market price, then the market price will rise reducing the amount buyers will purchase and increasing the amount sellers can produce. Thus, a change in market prices automatically eliminates surpluses or shortages of goods.

b. The Price Adjustment Process

Society is constantly undergoing changes in desires, production techniques, and availability of resources, and the market system must continually operate to adjust to these changes. In a market system, prices communicate nearly all the information required for such an adjustment. For example, let us assume, for the sake of simplicity, that all milk is used to produce three products: cheese, butter, and yogurt. Suppose, further, that it is suddenly discovered that yogurt has health-producing qualities that greatly increase the lifespan. As a result, consumers want more yogurt than ever before. The problem for the market system in the short run is how to allocate more milk to the production of yogurt and less to the production of cheese and butter, assuming, of course, that the milk cows are already giving their best effort.

The first step in the adjustment process is that grocery-store shelves become devoid of yogurt as shoppers stock up at prevailing prices. Grocers then clamor for more yogurt from producers in order to satisfy their customers before their competitors can do so. Yogurt producers would eagerly love to produce more yogurt, but since all milk is currently being used in production, yogurt producers must bid milk supplies away from cheese and butter producers in order to produce more yogurt. Grocers, who are trying to satisfy their customers before their competitors, offer a higher price for yogurt. Since grocers are offering higher prices for yogurt, yogurt producers can afford to pay more for milk supplies than can butter and cheese producers. Therefore, milk suppliers, being in the business for profit, sell more milk to yogurt producers and less to cheese and butter producers because of the higher prices. This higher price for milk will cause higher prices for butter and cheese, and consumers will consume less of these which frees milk for the production of yogurt. The primary result of this market activity is that more yogurt is produced for consumers and, in the long run, more milk will be produced because of the higher price of milk.

The effects of the change in consumers' desire for yogurt do not end with changes in the milk, butter, and cheese markets. In fact, the impact of this sudden discovery ripples through a number of industries. There will probably be a temporary shortage of margarine as consumers substitute it for the higher priced butter. The price of corn oil will increase as margarine producers increase their production, as will prices of other products that contain corn oil. If sheep graze on land used by dairy cows, the quantity of wool production will decrease as land is shifted to the use of dairy cows to produce the now higher priced milk. In fact, reverberations are experienced throughout many industries so that the impact of consumers' increased desire for yogurt is absorbed by many producers which greatly reduces the impact realized by any individual producer or industry. The fact that we rarely see shortages or surpluses or large price changes in goods that are allocated by the market system is testament to the fact that the adjustment process works very well indeed. This could be sharply contrasted with the huge shortages and surpluses of goods in government planned economies that do not use a price system to allocate resources.

c. Advantages of the Market System

An advantage of the market system is that individuals decide for themselves what is best for them and have the opportunity to pursue those activities that increase their own well-being. They are motivated by a self-interested profit incentive to secure the highest price for their resources. These resources will be purchased by those of the many competing users that have the highest valued use for these resources because it is such users who are willing to pay the highest price. The well-being of society is enhanced by each individual acting this way because each of society's resources is used in the most efficient manner possible to produce products and services for which individuals are willing to pay. Society is protected against an inefficient use of resources because it costs users, in terms of profits, to use resources inefficiently.

Another advantage of the market system is that it can constantly adjust to changes in consumers' tastes and desires because producers have a profit incentive to seek out information concerning what consumers want. The profit incentive also leads producers to develop and implement new technology which allows them to produce at a lower cost, which saves society's limited resources.

The market system also effectively coordinates economic activity. No one in the world knows how to make an automobile, yet, millions of them are produced every year. More specifically, no one individual knows how to perform the thousands of tasks necessary to manufacture an automobile such as mining the ore that makes the steel or refining the rubber that makes up the tires or manufacturing the plastics used in production. The market system provides incentives and rewards for individuals to engage in all these activities in order to produce the automobiles consumers want in the most efficient manner possible, but it also punishes those who fail.

Another advantage of the market system is that decision-making is decentralized. If a large number of people wanted the government to change one of its policies, it could take years for Congress to do so after much debate and consumption of resources. However, if a large number of people wanted a new product produced or even a different color of a current product, undoubtedly the self-interest of some producer would guide the producer to do so.

Resources in the market system are allocated according to decisions made by millions of individuals and producers. Millions of households decide how their budgets will be spent according to their preferences, and thousands of businesses compete not only to give consumers what they desire, but to do so by the most efficient means possible, so they can offer such goods and services at lower prices than their competitors. While mistakes are often made by participants in a market system, their impact is overwhelmed by correct decisions made by the vast majority of others. Moreover, the market system contains an anonymous and self-correcting mechanism -- people who make correct decisions are rewarded, those who make mistakes are punished, and, as a consequence, the people who make the best decisions tend to control the most resources. This decentralized system should be strongly contrasted with systems existing in countries that rely upon a centralized authority to allocate resources. When mistakes are made by those with concentrated economic decision-making power, their impact is felt throughout the entire society.

d. Disadvantages of the Market System

Under some fairly well-defined conditions, the market system fails to produce the maximum well-being achievable from a given amount of resources. It is due to these conditions that the majority of the government regulations of business have evolved. In this section, four widely recognized conditions will be discussed: transactions costs, information costs, lack of competition, and absence of property rights.

(1) Transactions Costs

The market system relies upon voluntary transactions to increase the well-being of society. As a result of a voluntary transaction, well-being increases because every party to the transaction gains something. In most cases, however, resources are used in order to consummate voluntary transactions. The use of resources to facilitate mutually beneficial transactions are referred to as **transactions costs.** Transactions costs may be the gasoline and time a buyer uses to make a purchase at a grocery store, they may be the cost of collecting debts of customers or of customers returning defective merchandise or of the risk of being injured by slipping on a store's wet floor. Therefore, resources are not only used to produce the goods and services themselves, but also to distribute the goods and services. High transactions costs reduce the number of transactions and by that, reduce the potential well-being that results from these transactions.

Often, the market system reduces transactions costs efficiently by creating a market for the reduction of these costs. For instance, real estate agents bring buyers and sellers of