# Business Law I

## Essentials

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# 8 Sales Contracts

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## Chapter Outline


**8.1** The Nature and Origins of Sales Contracts
**8.2** Warranties and Sales Contracts


## Introduction

### Learning Outcome

- Recognize nuances of contracts pertaining to sales.

## 8.1 The Nature and Origins of Sales Contracts

### Features of Sales Contracts

Commercial enterprises that engage in buying and selling practices need to be aware of the features and nature of **sales contracts**. A contract of sale is a specific type of contract in which one party is obligated to deliver and transfer ownership of a good to a second party, who in turn is obligated to pay for the good in money, or its equivalent. The party who is obligated to deliver the good is known as the **vendor** or seller. The party who is obligated to pay for the good is known as the **vendee** or buyer.

It has generally been established that there are six main features of sales contracts. Sales contracts are:

1. **Consensual**: they are perfected by mere consent without the need for any additional acts
2. **Bilateral**: both parties in the contract are bound to fulfill reciprocal obligations toward each other
3. **Onerous**: the good sold is conveyed in consideration of the price, and the price paid is conveyed in consideration of the good

4. **Commutative**: the good sold is considered to be the equivalent of the price, and vice versa
5. **Nominate**: this type of contract has a special designation (i.e., sale)
6. **Principal**: the validity does not depend upon the existence of other contracts

## Sources of Law for Sales Contracts

Only in very limited circumstances (such as in the buying and selling of stocks) does federal law govern sales contracts. Until the 1950s, there were two main sources of law for sales contracts: state common law and state statutory law. Thus, the laws governing sales contracts differed from state to state. As interstate commercial activity grew in importance, there was a need for a uniform law for sales transactions that would harmonize rules across the states. Therefore, in 1952, the **Uniform Commercial Code** (**UCC**)was created to govern business transactions. All 50 states have adopted the Code, but each has the power to modify it, in line with the wishes of the state legislature.

## The Uniform Commercial Code

The UCC categorizes items that can be bought or sold into three types:

1. **Goods** are defined in Section 2-105 of the UCC as tangible items “which are movable at the time of identification to the contract for sale.” Therefore, the primary features of goods are that they are movable and tangible. Refrigerators, paper, and furniture are all examples of goods.
2. **Services** are items that are movable but not tangible. Accounting is an example of a service.
3. **Realty** describes non-good items that are tangible but not movable. Under this definition, commercial and residential property are classed as realty.

These definitions have created some grey areas that have been clarified by the courts in their interpretation of the UCC. In the 2008 case Crown Castle Inc. et al. v. Fred Nudd Corporation et al., a case in which the telecommunications company Crown Castle sued a cell phone tower installation firm for the construction of faulty towers, the courts had to determine whether cell phone towers (monopoles) should be classified as movable (and hence goods) or non-movable (and therefore realty). Ultimately, it was determined that monopoles are goods. Items that are attached to realty (e.g. a counter or a bar) and that are used for business activities are described as **trade fixtures** and treated as goods. Software licenses are not tangible, but they are also not movable, and have been treated in different ways: as goods, a **mixed sale** (a tangible item tied to an intangible item), and pure services. Items such as soil and clay may be treated as goods even if they are part of immovable land because they can be extracted and moved. Crops that are sold while they are still growing on the land are also considered to be goods even though they are technically immovable while growing.

Article 2 of the UCC specifically pertains to sales contracts of goods. It defines a sale as a transaction that involves “the passing of title from the seller to the buyer for a price.” However, **merchants** are classified as a separate entity under the terms of the UCC. This distinction is important because the Code contains provisions that specifically apply to merchants and place greater duties on merchants to protect private citizens. There are four ways in which an entity can be classified as a merchant:

| Classification | Examples |
|---|---|

**Table 8.1**

| | |
|---|---|
| An agent who regularly sells goods as part of his or her business or trade | A seller on an online auction site |
| An individual who employs other people to sell goods | The owner of a clothing store |
| A person who works for a person who sells goods | An employee at a grocery retailer |
| Any entity who self-identifies as a merchant | An individual who describes himself or herself as a merchant in corporate documents |

**Table 8.1**

## Formation of Sales Contracts under the UCC

Sales contracts require most of the same components as general contracts, but the UCC includes some provisions that specifically pertain to the creation of sales contracts. First, the UCC includes a new category of **offer**. Basic contract law states that for an offer to be valid, it has to have "definiteness of terms." In the UCC, most of that particular rule is modified for greater flexibility. If the parties have "open" (in other words, "not definite") terms, the UCC addresses the situation with an overlay of "reasonableness"—for example, if no time for performance is designated, the performance must occur within a "reasonable" time. As a result, the following terms are legally allowed to be "open," and there is a "default" provision that will apply under the UCC:

| Open Term | Default | Applicable UCC Provision |
|---|---|---|
| Price | If price is not named, the default is "reasonable price." | UCC 2-305(1) |
| Payment | If payment is not named, default is "due at the time and place at which the buyer is to receive the goods." | UCC 2-310(a) |
| Delivery | If delivery is not named, the default is "buyer normally takes delivery at the seller's place of business." | UCC 2-308(a) |
| Duration of an Ongoing Contract | If duration of an ongoing contract is not named, the default is "buyer normally takes delivery at the seller's place of business." | UCC 2-308(a) |

**Table 8.2**

The only term that really *cannot* be left open is the **quantity** term. The court is not going to second-guess a quantity if the parties don't set one in the contract—for example, why would the court arbitrarily want to force the parties to buy and sell 15,000 widgets if a quantity wasn't specified? There are two exceptions to this rule: **requirements contracts** ("as much as I need") and **output contracts** ("as much as you can produce"). Even though these ideas are **illusory**, they're generally allowed in the commercial setting with good-faith limitations under UCC 2-306.

Sometimes, however, the courts will not allow purported "requirements" contracts. In one case, a court ruled that the contract was an unenforceable illusory contract instead of an enforceable requirements contract, even though it was a contract for the sale of goods ("as much as I need"). The reason for this ruling was that it did not appear that the buyer had any real intention of going through with any purchase.

Under Section 2-205 of the UCC, offers made by merchants are considered to be **firm offers** if the offers are made in writing and explicitly state that there is a three-month irrevocability period. A three-month irrevocability period is assumed if no mention is made with the offer. **Acceptance** of the offer can be made in any reasonable manner, but the **mirror-image rule** does not apply under the UCC. This means that if the terms of the acceptance do not mirror those of the offer, the acceptance is treated as a counteroffer and no legal contract is formed. Sale of goods contracts must be in writing if the value of the goods is $500 or more. Modifications to the contract must be made in good faith, and new consideration is not required. A contract provision, or the entire contract itself, can be considered to be **unconscionable** if its terms are unfair or unreasonable. If a court deems this to be the case, the contract, or certain provisions of it, may be unenforceable.

## Title

**Title** means ownership of a good. When the sale is completed, an agent must pass the title for the good to the buyer. There are three types of titles:

1. **Good title** describes a title that is obtained from an individual who owns the goods free and clear.
2. **Void title** occurs when the title is passed to the buyer from a person who does not legitimately own the title. An important point is that good faith is irrelevant when a void title is acquired. For example, a person who unknowingly purchased stolen goods has a void title. An exception occurs when an owner **entrusts** goods to a merchant who ordinarily deals in those goods, and then that merchant sells the goods to a good-faith buyer. In this case, the buyer acquires a good title. For example, if a motorcycle owner takes the motorcycle to a vehicle repair shop and the motorcycle is accidentally sold, the buyer acquires the title.
3. **Voidable title** occurs when the contract would have been good, but certain circumstances make it voidable. For example, if the buyer was deceitful about his or her true identity, the buyer is a minor, or the buyer wrote a bad check in the sale, then the title is deemed voidable.


**Figure 8.2** A sale is defined as a transaction that involves the passing of a title from the seller to the buyer for a price. (Credit: Negative Space/ pexels/ License: CC0)

## Issues Associated with Title

Imagine the following scenario: A café purchases a new coffee machine from a supplier. However, when the supplier tries to deliver the equipment to the café, it is involved in an accident and the coffee machine is destroyed. A question emerging from this scenario is this: Is the supplier legally obligated to replace the machine? Asked differently: Who holds the good title in this scenario?

Prior to the introduction of the Uniform Common Code, the loss would have fallen on the owner of the café, since he or she paid for the coffee machine prior to taking possession of it. Under the UCC, however, as long as the supplier is considered a merchant, the risk of loss remains with the merchant until the buyer takes possession of the good.

Given problems like the one described above, the UCC separately considers four specific issues relating to titles:

- **Ownership**. Under consideration is the question of *when* the title transfers from vendor to vendee, and hence when ownership is said to occur.
- The concept of **encumbrance** considers when the vendee is granted an interest in the good such that the good can be used as collateral for a debt.
- The UCC considers when the risk of **loss** attaches and what the responsibilities of the buyer and seller are to each other, should a loss occur.
- **Insurable interest** is the right to insure the goods against exposure to risk of loss or damage

The UCC allows four scenarios for sales contracts: simple delivery contracts, common-carrier delivery contracts, goods-in-bailment contracts, and conditional sales contracts.

Each type involves the title, risk of loss, and insurable interest passing at different times.

A **simple delivery contract** occurs when the goods are transferred from the buyer to the seller at the time of the sale or later, e.g., if the goods are delivered. Title transfers when the contract is executed, insurable interest passes at the same time, and risk of loss transfers when the buyer takes possession, unless the seller is not a merchant. In the latter case, under the rule of **tender of delivery**, risk remains with the buyer.

A **common-carrier delivery contract** occurs when a common carrier, who is an independent contractor rather than an agent of the seller (e.g., a trucking line), delivers the goods. The UCC further categorizes these types of contracts into shipment contracts and destination contracts:

1. A **shipment contract** occurs when it is the responsibility of the seller to make the shipping arrangements and to transfer the goods to the common carrier. Under this contract, title passes to the buyer at the time of shipment, so the buyer bears the risk of loss, even when he or she has not taken possession of the goods.
2. A **destination contract** occurs when the seller is required to deliver the goods to a location that is stipulated in the contract. Under this contract, title transfers when the goods are delivered, but the seller bears the risk of loss until that time.

A **goods-in-bailment contract** occurs when the goods are stored under the control of a third party, such as in a warehouse or on a ship. Transfer of title and risk of loss depends on whether the seller has a document indicating ownership of the goods and whether that document is negotiable or non-negotiable. A **negotiable** document contains the words, "deliver to the order of [seller]." As soon as that document is endorsed to the buyer, both title and risk pass to the buyer. A **non-negotiable** document lacks those words. Under these circumstances, title passes with the endorsement of the document, but risk of loss does not pass until the custodian of the goods is notified of the title. If a document of title is completely absent, title passes at the same time as the execution of the contract, but risk does not pass until the custodian is notified of, and acknowledges, the transaction. Insurable interest is created when either the buyer or seller has the title, risk of loss, or an economic interest in the goods.

Finally, a **conditional sales contract** is a contract that occurs when the sale is dependent on approval. For example, a sale-or-return agreement occurs when both parties agree that the buyer can return the goods at a later date. Insurable interest is created once the goods are identified in the contract. Title and risk of loss depend on whether the goods are delivered by the common carrier, the seller, or in bailment, as described above.

## The International Sale of Goods

With globalization, there has been a significant expansion of commercial transactions undertaken across international borders. The **United Nations Convention on Contracts for the International Sale of Goods**, or the CISG, is the main legal structure offered for the governance of international commercial transactions. The CISG broadly covers the same topics as the UCC, but it preempts the UCC if there is a problem with an international sale.

# 8.2 Warranties and Sales Contracts


**Figure 8.3** The law provides remedies for breach of sales contracts. (Credit: rawpixel/ pexels/ License: CC0)

## Warranties

A **warranty** is a guarantee on the good that comes as part of the sales contract, but contract law treats warranties as an additional form of contract that binds the selling party to undertake a certain action. Typically, the selling party has an obligation to provide a product that achieves a specified task, or to deliver a service that meets certain minimal standards. Warranties are offered for a range of different goods and services, from manufactured goods to real estate to plumbing services. The warranty assures the buyer that the good or service is free from defects, and it is a legally binding commitment. In the event that the product or service fails to meet the standards set out in the warranty, then the contract provides a specific remedy, such as a replacement or repair.

According to UCC 1-203, the performance and execution of all contracts must be undertaken in good faith. **Good faith** means honesty in fact and the observance of reasonable commercial standards of fair dealing. If the parties in the contract are merchants, the UCC also requires that the contract be undertaken in accordance with **commercial reasonableness.** This requirement means that the transaction should be undertaken in a sensible and prudent way.

## Express and Implied Warranties

Warranties can be express, implied, or both. Both express and implied warranties provide legal relief for the purchaser in the event of a breach of contract.

An **express warranty** is one in which the seller explicitly guarantees the quality of the good or service sold. Typically, the vendor provides a statement, or other binding document, as part of the sales contract. What this means in practice is that the buyer has engaged in the contract on the reasonable assumption that the quality, nature, character, purpose, performance, state, use, or capacity of the goods or services are the same as those stated by the seller. Therefore, the sales contract is based, in part, on the understanding that the goods or services being supplied by the seller will conform to the description, or any sample, that has been provided.

There are myriad ways in which the seller can make statements as to the characteristics of the goods.

Here are a few examples of express warranties:

“Wrinkle-free shirt”

“Lifetime guarantee”

“Made in the USA”

“This orange juice is not from concentrate”

“24k gold”

There is not a specific way that words must be formed to make an express warranty valid. Importantly, the sales contract does not need to explicitly state that a warranty is being intended. It is enough that the seller asserts facts about the goods that then become part of the contract between the parties. However, the courts do apply a **reasonableness test of reliance** upon warranties. Puffery, or language used to bolster sales, is lawful, and the consumer is required to apply reason when evaluating such statements. For example, buyers are expected to use reason when judging seller claims such as “this sandwich is the best in the world.” Obvious sales talk cannot ordinarily be treated as a legally binding warranty.

A **breach** of the warranty occurs when the express warranty has been found to be false. In such circumstances, the warrantor is legally liable just as though the truth of the warranty had been guaranteed. The courts do not accept as a defense:

- Seller claims the warranty was true.
- Seller claims due care was exercised in the production or handling of the product.
- Seller claims there is not any reason to believe that the warranty was false.

## Implied Warranties

In certain circumstances where no express warranty was made, the law **implies** a warranty. This statement means that the warranty automatically arises from the fact that a sale was made. With regard to implied warranties, the law distinguishes between casual sellers and merchant sellers, with the latter held to a higher standard, given that they are in the business of buying or selling the good or service rendered. For example, unless otherwise agreed, goods sold by merchants carry an implied warranty against claims by any third party by way of trademark infringement, patent infringement, or any other intellectual property law infringement. This type of warranty is known as the **warranty against infringement.** Another implied warranty provided by merchant sellers is the **warranty of fitness for normal use**, which means that the goods must be fit for the ordinary purposes for which they are sold.

It is important to note that if express warranties are made, this does not preclude implied warranties. If an express warranty is made, it should be consistent with implied warranties, and can be treated as cumulative, if such a construction is reasonable. If the express and implied warranties cannot be construed as **consistent** and **cumulative**, the express warranty generally prevails over the implied warranty, except in the case of the implied **warranty of merchantability**, or fitness for purpose.

## Breaches of Warranty

If the buyer believes that there has been a breach of the implied warranty of merchantability, it is their responsibility to demonstrate that the good was defective, that this defect made the good not fit for purpose, and that this defect caused the plaintiff harm. Typical examples of defects are:

- Design defects
- Manufacturing defects
- Inadequate instructions on the use of the good
- Inadequate warning against the dangers involved in using the good.

## Specific Examples of Goods Under the Warranty of Merchantability

| Type | Description |
|---|---|
| Second-hand goods | The UCC treats warranties arising for used goods in the same way as warranties arising for new goods, but second-hand products tend to be held to a lower standard on the warranty of merchantability. |
| Buyer-designed goods | The same warranties arise for mass manufactured goods as for goods that have been specified or made to order for the buyer. However, in this case, no warranty of fitness for purpose can arise since the buyer is using his or her own decisions, skill, and judgment when making the purchase. |
| Food and drink | The sale of food or drink carries the implied warranty of being fit for human consumption. |

**Table 8.3**

The buyer might intend to use the goods purchased for a different purpose than that for which it was sold. In this case, the implied warranty holds only if the buyer relies on the seller's skill or judgment to select the product, the buyer informs the seller at the time of purchase of his or her intention for the use of the good, and the buyer relies on the seller's judgment and skill in making the final choice. If the seller is not made aware of the buyer's true intention, or does not offer his or her skill and judgment in aiding the sale, then warranty of fitness for a particular purpose does not arise. For this reason, it is common for vendors to include provisions in the average terms and conditions of sale with regard to the true and intended purpose of use.

## Warranty of Title

By the mere act of selling, the vendor implies a warranty that the title is good and that the transfer of title is lawful. In addition, the act of the sale creates a warranty that the goods shall be delivered free from any lien of which the buyer was unaware. In some circumstances, the warranty of title can be excluded from the contract documents. For instance, when the seller makes the sale in a representative capacity (e.g. as an executor of an estate), then a warranty of title will not arise.

## Remedies to Buyers under the UCC

| Remedy | Description |
|---|---|
| Cancel the contract | The UCC allows buyers to cancel the contract for nonconforming goods and to seek remedies that give them the benefit of the bargain. |
| Obtain cover | Buyers are allowed to substitute goods for those due under the sales contract. However, substitutes must be reasonable, acquired without delay, and obtained in good faith. |
| Obtain specific performance | If the goods are unique or a legal remedy is inadequate, the seller may be required to deliver the goods as identified in the contract. |
| Sue | Buyers are entitled to consequential and incidental damages if there is a breach of contract. They may also be able to obtain liquidated damages (damages before the breach occurs) or punitive damages. |

**Table 8.4**

## Assessment Questions

**1.** What is a sales contract?

**2.** All of the following are features of sales contracts except:
   a. Consensual.
   b. Bilateral.
   c. Cumulative.
   d. Principal.

**3.** What source of law governs sales contracts?
   a. Common Law.
   b. The Uniform Commercial Code.
   c. Statutory Law.
   d. Federal Law.

**4.** What is the definition of a good?

**5.** Distinguish a shipment contract from a destination contract.

**6.** What is a warranty in a sales contract?

**7.** Describe the difference between an express and implied warranty.

**8.** Examples of a defect in a breach of the implied warranty of merchantability, include all of the following except:

a. Design defect.
b. Manufacturing defect.
c. Inadequate instructions.
d. Product defect.

**9.** The following are possible remedies to buyers under the UCC:

a. Cancel the contract.
b. Obtain Cover.
c. Sue.
d. All of the above.

**10.** What is a breach of warranty?

## Endnotes

Kubasek, N., Browne, M. N., Dhooge, L. J., Herron, D. J., Williamson, C., & Barkacs, L. L. (2015). *Dynamic business law*. McGraw-Hill Education.

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# 9 Employment and Labor Law

**Figure 9.1** (Credit: rawpixel/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

## Chapter Outline


**9.1** Employment, Worker Protection, and Immigration Law
**9.2** Labor Law
**9.3** Equal Opportunity in Employment


## Introduction

### Learning Outcome

- Analyze various laws governing employer/employee relationships.

## 9.1 Employment, Worker Protection, and Immigration Law

Compared to other countries in the West, stringent and extensive employee protections came fairly late to the United States. Up until 1959, for example, employers had the right to fire a worker without giving any reason. This concept, which was was known as **at-will employment**, was applicable in all states. The concept of at-will employment does, however, continue today, and all employees are considered to be at-will unless they are employed under a collective bargaining agreement, or under a contract for a set duration. Employers can still fire employees for any reason, but they cannot be fired for illegal reasons, as set out in the U.S. or state constitutions, federal law, state statutes, or public policy. In this section, some of the main employee rights and company responsibilities will be introduced.

**Figure 9.2** Employees have various rights in the workplace and companies have various responsibilities toward them. (Credit: Raw Pixel/ pexels/ License: CC0)

## Health and Safety

Workers have the right to be safe at work, and companies have responsibilities to employees in the event that they are harmed while undertaking work on behalf of the employer. The **Occupational Safety and Health Act**, passed in 1970, is the main legislative action that governs health and safety in the workplace. The Act established the **Occupational Safety and Health Administration** (OSHA), which is a federal agency whose role is to "assure safe and healthy working conditions for working men and women by setting and enforcing standards and by providing training, outreach, education and assistance." Private employers and federal government agencies are all covered under OSHA protection, although the self-employed and workers at state and local governments in most states are not covered. OSHA has adopted thousands of regulations to enforce the Occupational Safety and Health Act. It imposes a number of record-keeping and reporting requirements on private employers. In addition, employers are required to inform employees of their health and safety rights by posting appropriate notices in the workplace.

| Type of OSHA Standard | Description | Example |
|---|---|---|
| Specific Duty Standards | Standards that apply to specific types of work, procedures, work conditions, and equipment | Safe handling of compressed gas cylinders |

**Table 9.1**

| | | |
|---|---|---|
| General Duty Standards | Standards that apply to all employers and that impose a duty to protect workers from known hazards | Standards pertaining to indoor air quality and workplace violence |

**Table 9.1**

**Workers' Compensation Acts** help employees claim compensation for injuries that occur on the job. States require employers to either purchase workers' compensation insurance, or have the ability to self-insure against compensation claims. Workers' compensation insurance covers a range of different injuries, including physical injuries, mental illnesses that can be shown to be employment-related, and stress.

Under the terms of the Acts, a **Workers' Compensation Agency** is established at the state level to provide judicial and administrative services to help in the resolution of claims for compensation. In the event of a claim, a three-step process is put into place:

1. The worker files a claim with the agency.
2. The agency establishes the legitimacy of the claim.
3. If the injury is determined to be legitimate, compensation benefits are paid accordingly.

It is important to note that workers' compensation is understood to be an **exclusive remedy**. This term means that workers cannot sue the employer in court for further damages beyond that which is paid out under the compensation claim. An exception is made when the employer intentionally injures the worker, however. Furthermore, workers have the right to sue any third party involved in the cause of the injury to recover additional damages.

### Case Insight

In the case Chad A. Kelley v. Marsha P. Ryan, Administrator, Ohio Bureau of Workers' Compensation, and Coca-Cola Enterprises, Chad A. Kelley attended a team-building event held by his employer, Coca-Cola, to celebrate the launch of a new product. All employees attending the event were required to canoe down a river, which Kelley, with colleagues, achieved without incident. Employees waiting on the river bank began to splash one another, and according to witnesses, Kelley said that it would take more than some splashing to get him wet. Consequently, several colleagues tried to throw Kelley into the water, which led him to sustain neck injuries. The Ohio Bureau of Workers' Compensation denied Kelley's claim for benefits, however, arguing that Kelley had instigated "horseplay" that removed the incident from the scope and course of employment. In 2009, an appellate court ruled that this conclusion was incorrect and that the employer was, in fact, responsible. Kelley was entitled to the compensation.

## Fair Labor Standards Act

The Fair Labor Standards Act (FLSA) sets out provisions that delineate fair labor and unfair labor. There are three main categories covered in the Act:

1. Child labor
2. Minimum wage provisions
3. Overtime pay requirements

The FLSA prohibits oppressive **child labor** as well as the shipping of goods produced by firms that make use of oppressive labor. The FLSA sets the minimum age for non-agricultural work as 14. However, there are some exceptions. People under the age of 14 who are classed as minors may deliver newspapers, perform babysitting or chores around the home, and can work in businesses owned by their families, as long as the work is not deemed to be hazardous. In addition, minors may perform in television, radio, movie, or theatrical productions. Once an employee becomes 18, child labor regulations no longer apply.

Under the terms of the FLSA, employees in covered industries, with the exception of apprentices and students, must be paid the federal minimum wage. Congress is responsible for reviewing the level of the minimum wage on a periodic basis and raising it to compensate for increases in the cost of living caused by inflation. In 2009, Congress raised the federal minimum wage to $7.25 an hour. This increase was the first in almost a decade (although in 2014, President Obama signed an executive order that increased the minimum wage to $10.10 for those employed on new federal contracts).

FLSA also mandates that employees who work more than 40 hours in a week should receive overtime pay that is equal to at least one and one-half times their regular wage for every additional hour worked. Four categories of employees are excluded from this provision, however: executives, administrative employees, professional employees, and outside salespersons.

## Family and Medical Leave Act

The Family and Medical Leave Act (FMLA), enacted in 1993, guarantees all eligible workers up to 12 weeks of unpaid leave during any 12-month period for family and medical emergencies. The FMLA applies to all public and private employers with 50 or more employees, covers employees who have worked for the employer for at least one year, and applies to employees who have worked at least 25 hours a week for each of 12 months prior to the leave. The events that qualify workers for leave are:

- The birth of a child
- The adoption of a child
- The placement of a foster child in the employee’s care
- The care of a seriously ill spouse, parent, or child
- Any serious health condition that prevents the worker from being able to perform any of the essential functions of the job

Once the employee returns to work, he or she must be restored to the same or equivalent position. **Social Security** benefits also provide benefits to certain employees and their dependents. The types of benefits that fall under Social Security regulations include disability benefits, Medicare benefits, survivors’ benefits, and retirement benefits.

## Ending Employment

There are are also several regulations that cover workers who are terminated or who lose their employment. These are summarized in the following table.

| Regulation | Description |
| --- | --- |

**Table 9.2**

| | |
|---|---|
| Consolidated Omnibus Budget Reconciliation Act (COBRA) | Mandates that employees who are terminated must be provided with the opportunity to continue to participate in group health insurance, so long as they agree to pay the group rate premium. The employer is required to notify employees of their COBRA rights. |
| Employee Retirement Income Security Act (ERISA) | This Act covers any pension plan offered by employers to their workers, and is designed to prevent abuses and fraudulent use of those plans. Under the terms of ERISA, employers are required to keep certain records pertaining to the plans, and to report on those records at regular intervals. The Act also provides for **vesting**, which occurs when an employee has a nonforfeitable right to receive pension benefits. |
| Unemployment compensation | Unemployment compensation programs are paid to those who become temporarily unemployed, and are funded by employers through employment taxes. Workers who quit voluntarily or who are terminated for bad conduct are not eligible for compensation. In addition, in order to qualify for the benefits, applicants must demonstrate that they are available for work. |

**Table 9.2**

### Immigration Law

There are vast areas of immigration law that are applicable to employment. The U.S. Citizenship and Immigration Service (USCIS) administers a range of different immigration programs that enable U.S. employers to employ foreign national workers. For example, under the EB-1 visa, U.S. employers can employ foreign nationals who have **extraordinary ability** for certain types of work. Under the terms of the Immigration Reform and Control Act (IRCA), employers are required to examine evidence of employees' identity and complete mandatory paperwork for each employee. There are serious financial and criminal penalties for employers who knowingly hire undocumented workers.

## 9.2 Labor Law

**Labor relations** is the general term used to describe the relationship between employers and employees, as well as governance of that relationship. It refers to the micro-level interactions that take place between workers and individual managers, as well as the macro-level relations that occur between the external institutions that are tasked with governing such relations. This understanding of labor relations acknowledges the fact that there is a plurality of interests that must be taken into account in the processes and procedures of negotiation, bargaining, and dispute settlement relating to the workplace. It also recognizes that employees and employers' representatives are fundamental to the process of industrial relations, and that the state plays a key role in the development of labor laws, the regulation of collective bargaining, and the administration of disputes. There has been considerable flux and development in the nature of U.S. labor over the past century. However, the most substantial changes have occurred since the 1950s. Changes have been particularly evident in the role that the state has been expected to play in employment relations between workers, their representatives, and their employers. This section introduces some of the key milestones in labor relations in the United States, and describes the role played by **trade unions** in governing the relationship between employers and employees.

## What Is a Trade Union?

A trade union, or labor union, is an organized group of workers who come together to lobby employers about conditions affecting their work. There currently are around 60 unions representing 14 million workers across the United States. Unions are organized according to the type of work that workers do. For example, the American Federation of Teachers is the labor union for teaching personnel, while the the International Association of Fire Fighters covers fire fighters. Many unions in the United States are organized as **local unions**. This type of union is a locally (i.e., company or region) based group of workers who organize under a charter from a national union. For example, Affiliated Property Craftspersons Local 44 is the Los Angeles union of entertainment professional craftpersons, chartered under the International Alliance of Theatrical Stage Employees.

## Timeline of Developments in Labor Law

- **1886.** The American Federation of Labor was formed in Columbus, Ohio. This group was a national federation of labor unions who came together to bolster their power in industrial unionism. The AFL was the largest union grouping in the United States well into the twentieth century. However, the Federation was craft-dominated, such that only craft workers like artisans and silversmiths were allowed to belong.
- **1932.** The Norris-LaGuardia Act was passed. This Act prohibited **yellow-dog contracts**, or contracts that prevented workers from joining labor unions. In addition, federal courts were barred from issuing injunctions to prevent groups of workers from engaging in boycotts, strikes, and picketing.
- **1935.** The Congress of Industrial Organizations was established. This establishment extended the union movement because it allowed semi-skilled and unskilled workers to become members.
- **1935.** The Wagner Act, or **National Labor Relations Act**, was passed. This Act is the major statute of United States labor law. The Act established that employees have the right to form, assist, and join labor organizations, to engage in collective bargaining with employers, and to engage in concerted activity to promote those rights.
- **1947.** The Labor-Management Relations Act, also known as the Taft-Hartley Act, imposed restrictions on the power of labor unions. It made changes to union election rules and outlined and provided remedies for six unfair practices by labor unions (see box below).
- **1959**. The Labor Management Reporting and Disclosure Act, or Landrum-Griffin Act, was passed, which regulates the internal affairs of trade unions, as well as their officials’ relationships with employers. All union members are granted equal rights to vote for candidates, take part in membership meetings, and nominate candidates for office.
- **1988**. The Worker Adjustment and Retraining Notification (WARN) Act requires that employers with more than 100 employees give workers at least 60 days notice before engaging in layoffs or plant closings.

| Amendments of the Taft-Hartley Act | Description |
|---|---|

**Table 9.3**

| | |
|---|---|
| 1 | Protects employees from unfair coercion by unions that could lead to discrimination against employees. |
| 2 | States that employers cannot refuse to hire prospective workers because they refuse to join a union. This amendment also grants the employer the right to sign an agreement with a union that requires the employee to join the union before the employee’s 30th day of employment. |
| 3 | Unions must bargain in good faith with employers. |
| 4 | Prevents unions from engaging in secondary boycotts. |
| 5 | Prevents unions from taking advantage of either employers or members. For example, unions cannot charge members excessive membership dues or cause employers to pay for work that has not been performed. |
| 6 | Grants employers the right to free speech. Expressed opinions about labor issues do not constitute unfair labor practices, as long as the employer does not threaten to withhold benefits from, or engage in, retribution against the worker. |

**Table 9.3**

## The National Labor Relations Board

The National Labor Relations Board (NLRB) was established to administer, interpret, and enforce the terms of the National Labor Relations Act. It has jurisdiction over all workers, except for government employees and employees in the transportation industry, who are governed under a separate statute (The Railway Labor Act). Other workers not covered by the NLRB include agricultural workers, confidential employees (employees who develop or present management’s position or who have access to confidential information related to bargaining employees), independent contractors, and those employed by a spouse or a parent. The NLRB has three main functions:

1. To monitor the conduct of unions and employers during elections to determine whether employees wish to be represented by a union
2. To remedy and prevent unfair labor practices by unions or employers
3. To establish rules interpreting the NLRA


**Figure 9.3** Under the terms of the National Labor Relations Act, employees have the right to strike as part of their efforts to secure better working conditions. (Credit: Geralt/ pixabay/ License: CC0)

## Organizing a Union

For a union to be formed and organized, the union must identify an **appropriate bargaining unit.** This term is used to describe the group of workers that the union is looking to represent. Under the terms of the **inaccessibility exception,** employees and union officials have the right to engage in union solicitation on the firm's property if they cannot otherwise access employees to communicate with them. The next stage is to run an election. There are three types of elections:

- **Consent election.** This election is held when there are not any substantial issues under dispute between the union and the employer. Both parties agree to waive the pre-election hearing.
- **Contest election**. This election is for a union that is contested by the employer. The NLRB is required to supervise this kind of election.
- A **decertification election** is held when employees indicate that they wish to vote out the union or join another.

In order to try to bolster their power, elected unions often attempt to install a **union security agreement.** This agreement pertains to the extent to which the union can demand that employees join the union, and whether the employer will be required to collect fees and dues on behalf of the union. A **closed shop** is a workplace where union membership is a requirement for employment. A **union shop** is a place of employment where the employee is required to join the union within a specified number of days after being hired. An **agency shop** is a workplace that does not require the employee to join the union, but where agency fees to the union must be paid. Union security agreements are the outcome of collective bargaining agreements.

## Collective Bargaining

Collective bargaining involves the union and the employer negotiating contract terms. The outcome is known as a **collective bargaining agreement.** The types of terms that are usually negotiated are wages and salaries, hours, and the terms and conditions of employment. If union members dispute working conditions, unfair labor practices, or economic benefits, they have the right to participate in a cessation of work activities, known as a **strike**. There is a mandatory cooling off period of sixty days before a strike can commence. Some collective bargaining agreements include no-strike clauses. Although strikes are permitted according to the NRLA, some strikes are illegal:

- Violent strikes
- Sit-down strikes
- Wildcat (unauthorized) strikes
- Intermittent, or partial strikes

In addition to striking, union members have the right to picket. This process involves walking in front of the employer's premises with signs that advertise the strike and the union's demands. Picketing is lawful as long as it does not:

- Involve violence
- Prevent customers from entering the premises
- Prevent non-striking workers from entering the premises
- Prevent the business from receiving deliveries or pickups

**Secondary boycott picketing** occurs when the union pickets the employer's customers or suppliers. This type of picketing is legal if it is product picketing, but illegal if the picket is directed against a neutral business.

## 9.3 Equal Opportunity in Employment

### A Landmark Case

In 1982, the financial services company Price Waterhouse announced a vacancy for the position of partner. Ann Hopkins, an employee of the company at the time, applied, but after an assessment, was passed over. Hopkins sued the company, arguing that she had billed more than $34 million in consulting contracts for the firm, far more than any of the other 87 candidates, who were all male. In rejecting her application, the partners at the company argued that Hopkins was "too macho" and that she should "walk more femininely, talk more femininely, dress more femininely, wear makeup, have her hair styled and wear jewelry." In the landmark legal suit that followed, Hopkins was awarded $371,000 in back pay, and Price Waterhouse was forced to make her a partner.

### Laws Governing Equal Opportunity in Employment

Employees are protected in the workplace by a number of laws enacted at both the federal and state levels. Federal laws are usually considered to be the minimum level of protection, and state laws can provide employees with more, but not less, protection. In this section, the major laws pertaining to equal opportunity are discussed.

### Civil Rights Act of 1964 – Title VII (Amended By the Civil Rights Act of 1991)

The Civil Rights Act provides broad provisions pertaining to citizens' civil rights. Title VII of the Civil Rights Act deals with discrimination in employment. It bans employers from discriminating against employees in their hiring, firing, and promotion practices on the basis of sex, national origin, color, religion, or race. All employers who are engaged in commercial activity and who employ 15 or more employees for 20 consecutive weeks in a year are covered by the Act. The Act also sets out the two main ways in which discrimination can be proven: disparate treatment and disparate impact.

**Disparate treatment** means that the employee believes that he or she has been discriminated against on the basis of one of the protected classes set out in the CRA. Proving that the employer engaged in disparate treatment is a three-step process:

1. The employee (plaintiff) is required to demonstrate a **prima facie** (accepted as correct unless proven otherwise) case of discrimination.
2. The employer (defendant) must show legitimate, non-discriminatory business reasons for undertaking the action.
3. The employee must demonstrate that the reason given by the employer is a mere pretext.

A trier of fact, usually a jury, will use the evidence presented to determine whether discrimination did in fact occur. If the jury finds for the employee-plaintiff, damages can be awarded, such as what occurred in the landmark Ann Hopkins case, described in the opening box. If the jury finds for the employer-defendant, no damages are assessed.

| Damages Permissible Under Title VII of the CRA |
| --- |
| Up to two years of back pay |
| Compensatory damages |
| Punitive damages |
| Remedial seniority |
| Costs (e.g., attorney fees and court costs) |
| Court orders (e.g., reinstatement) |

**Table 9.4**

**Disparate impact** cases are cases of unintentional discrimination. This type of case occurs when the employer engages in a practice that has a disproportionately injurious impact on a protected class. Disparate impact cases are difficult to prove. The burden of responsibility is on the employee-plaintiff to statistically establish that the action impacts the protected class. The defendant can avoid liability by demonstrating that the practice is a business responsibility. The burden of proof then shifts to the employee to prove that the alleged business necessity is a mere pretext. These steps were established in Griggs v. Duke Power Co. Duke Power required all job applicants to have a high school diploma and to reach a certain minimum score on a professional intelligence test. Willie Griggs, the plaintiff, established that the rule was racially discriminatory because only 12 percent of black men in the state had high school diplomas (compared to 34 percent of white men), and only 6 percent of blacks had passed similar intelligence tests, compared to 58 percent of whites. Duke Power tried to argue that the provisions were necessary to upgrade the quality of the workforce, but the court did not agree that this defense was an adequate business-related justification, and the plaintiff was successful.


**Figure 9.4** Employees are protected against discrimination by employers by a number of laws enacted at both the federal and state level. (Credit: Wokandapix/ pixabay/ License: CC0)

**Sexual harassment** is also protected under Title VII. This type of harassment is defined as unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature. Two types of sexual harassment are recognized. **Quid pro quo** occurs when a manager makes a sexual demand on a worker, and this demand is perceived as a condition of employment. Actions that create a **hostile work environment** are another type of sexual harassment. These issues have been used in cases of discrimination based on race and religion as well as sex. Since the 1997 case Oncale v. Sundowner Offshore Services Inc., it has been established that sexual harassment undertaken by a member of one sex against a member of the same sex is actionable under Title VII. In some limited circumstances, employers may also be liable for harassment of employees by non-employees, e.g., customers. The employer is liable if it does nothing to prevent and remedy harassment targeted at one of its employees. The **Pregnancy Discrimination Act** of 1987 expanded the definition of sex discrimination to include discrimination based on pregnancy, childbirth, or medical conditions related to the same.

## Defenses to Title VII Claims

| Defense | Description |
| --- | --- |

**Table 9.5**

| | |
|---|---|
| The Bona Fide Occupational Qualification Defense (BFOQ) | Using this defense, the employer can discriminate if it is deemed to be necessary for the performance of the job. Necessity, however, must be determined on the basis of actual qualifications, rather than stereotypes about the abilities of a certain class. For example, an employer is not expected to hire a man as a model for women's clothes. Hires on the basis of sexual privacy are covered under BFOQ. However, there are no BFOQs for discrimination on the basis of race or color. |
| The Merit Defense | This defense is used when decisions pertaining to hiring or promotion are made on the basis of the results of test scores. However, tests must be validated in accordance with professional standards and must be manifestly related to job performance. |
| The Seniority Defense System | This defense system occurs when employees are given preferential treatment because of their length of tenure. As long as the system does not have its genesis in discrimination, and is not used to discriminate and applies to all persons equally, it is lawful. |

**Table 9.5**

## The Equal Pay Act

The Equal Pay Act (EPA) is a United States federal law that seeks to equalize the salaries and wages paid to employed women with the levels paid to men for work of an equal nature and quantity. The Act amended the Fair Labor Standard Act of 1938 and was a key element of President F. Kennedy's New Frontier program. Under the terms of the EPA, women and men performing jobs that demand "equal skill, effort, and responsibility, and which are performed under similar working conditions" must be paid the same. The Act protects the rights of both sexes. An individual who seeks to establish a case under the Act must demonstrate that:

1. An employer pays one sex more than another
2. Both sexes perform an equal amount of work that demands equal levels of skill, effort and responsibility
3. Working conditions for both sexes are equivalent

An employer that is accused of discrimination under the EPA can present one of four **affirmative defenses**. An employer may legally pay employees of one sex more than another sex if wages are based on a system of seniority, a system of merit, a system that distinguishes payment on the basis of quality and quantity of production (e.g., certain piece rates), or if payment is differentiated on "any other factor other than sex." Of these four defenses, the "factor other than sex" defense has been invoked most frequently and has been the subject of intense debate and controversy. Critics have argued that this defense enables employers to fabricate other reasons for the wage gap.

## Americans with Disabilities Act

The Americans with Disabilities Act (ADA) prevents employers from discriminating against workers on the basis of their physical or mental disabilities. In addition, employers are required to make reasonable accommodations to known disabilities, as long as such accommodations do not impose an undue burden on the business. To bring a successful ADA claim, the plaintiff is required to demonstrate that he or she:

- Has a disability
- Suffered an adverse employment decision because of that disability

- Was otherwise qualified for the position

ADA is enforced in a similar way to Title VII, and remedies for ADA violations are also similar.

## Age Discrimination Act

Passed in 1967, this Act prohibits employers from making discriminatory employment decisions against people age 40 or older. This Act applies to all employers with 20 or more employees.

## Assessment Questions

**1.** What does At-Will Employment mean?

**2.** Employers are required provide a work environment that is safe and healthy for their employees by which law?

a. FLSA.
b. WCA.
c. OHSA.
d. FMLA.

**3.** How many weeks of unpaid leave does the Family Medical Leave Act guarantee to eligible workers?

a. 12.
b. 16.
c. 25.
d. 40.

**4.** What regulation protects employees who are terminated from their employment?

a. COBRA.
b. ERISA.
c. Unemployment Compensation.
d. All of the above.

**5.** The Fair Labor Standards Act (FLSA) covers which category?

a. Child Labor.
b. Minimum wage.
c. Overtime pay.
d. All of the above.

**6.** Explain the term labor relations.

**7.** What is a trade union?

**8.** What is the function of the National Labor Relations Board?

a. To monitor the conduct of the unions and employers during union elections.
b. To remedy and prevent unfair labor practices by unions or employers.
c. To establish rules interpreting the NLRA.
d. All of the above.

**9.** _____ is a place of employment where the employee is required to join the union within a specified number of days after being hired.

a. A closed shop.
b. A union shop.
c. An agency shop.
d. A secure shop.

**10.** Which of the following practices are illegal?

a. Picketing.
b. No strike clause.
c. Sit-Down strike.
d. A secure shop.

**11.** Explain Title VII of the Civil Rights Act of 1964.

**12.** How do you prove a disparate impact case?

**13.** The following is valid defense under Title VII:

a. Quid Pro Quo.
b. No Merit Defense.
c. BFOQ
d. All of the above.

**14.** To bring a successful claim under the Americans with Disability Act ("ADA"), the plaintiff must prove all of the following except:

a. He or she suffered an adverse employment decision because of a disability.
b. The disability was not a mental disability.
c. He or she was qualified for a position.
d. He or she has a disability.

**15.** The Age Discrimination Act only applies to employers with 20 or more employees.

a. True.
b. False.

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# 10 Government Regulation

**Figure 10.1** (Credit: JamesDeMers/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

## Chapter Outline


**10.1** Administrative Law

**10.2** Regulatory Agencies


## Introduction

### Learning Outcome

- Define the role of administrative bodies and regulation in the governmental rulemaking process.

## 10.1 Administrative Law

**Administrative law** is also referred to as **regulatory** and **public law**. It is the law that is related to administrative agencies. Administrative agencies are established by statutes and governed by rules, regulations and orders, court decisions, judicial orders, and decisions.

Agencies are created by federal or state governments to carry out certain goals or purposes. Federal agencies are created by an act of Congress. Congress writes out a law called an **organic statute** that lays out the purpose and structure of the agency. The agency is charged with carrying out that purpose, as described by Congress. **Organic statutes** are utilized to create administrative agencies, as well as to define their responsibilities and authority.

**Figure 10.2** Both federal and state legislators create agencies to fulfill a specific purpose, usually related to protecting the public from a potential threat. (Credit: kbhall17/ pixabay/ License: CC0)

## Industrialization

Administrative agencies have been around almost since the founding of the United States. However, **industrialization** had a big impact on the development of administrative laws. As people moved from farms and rural areas to cities to find work and raise families, the economy changed. It became more complex. As a result of this economic change, the government saw a need to expand its regulation to protect and support the public. In the 20th century, the number of agencies expanded very quickly with the addition of the Food and Drug Administration (FDA) to regulate food and medication, the Federal Trade Commission (FTC) to regulate trade, and the Federal Reserve System (FRS) to regulate banks. These are just a few of the agencies created to regulate industries. Ultimately, this expansion occurred in response to the complexity of the economy.

**Figure 10.3** Industrialization increased the number of administrative agencies in the United States. (Credit: Chevanon Photography/ pexels/ License: CC0)

## Everyday Impact

Administrative law impacts the public on a daily basis. Administrative law is basically the delegated power granted to administrative agencies to carry out specific functions. Government agencies endeavor to protect the rights of citizens, corporations, and any other entity through administrative laws. Administrative agencies were developed to protect consumers and the community. As a result, they are present in all aspects of life, including medicine, food, environment, and trade.

One well-known federal agency is the Food and Drug Administration (FDA). The FDA was created to protect the public's health. The agency's responsibilities are very broad. The agency fulfills its role by ensuring the safety and effectiveness of drugs consumed by people and animals, biological products, medical devices, food, and cosmetics. Specifically, the FDA regulates the things that the public consumes, including supplements, infant formula, bottled water, food additives, eggs, some meat, and other food products. The FDA also regulates biological items and medical devices, including vaccines, cellular therapy products, surgical implants, and dental devices. This federal agency began in 1906 with the passing of the Pure Food and Drugs Act.

**Figure 10.4** The Food and Drug Administration (FDA) oversees the safety and effectiveness of medication. (Credit: Rawpixel/ pexels/ License: CC0)

EpiPens are automatic injection devices that deliver lifesaving medication that can save an individual in the event of exposure to an allergen, like a bee sting or peanuts. The United States faced a shortage of EpiPens, so in 2018, the FDA took action to address this issue. The FDA approved the extension of EpiPen expiration dates for four months on specific lots of the EpiPen. This extension impacted both the public and the organization that produces EpiPens. In the same year, the FDA approved the first generic EpiPen. The new generic version will be produced by a pharmaceutical company that has not previously produced the EpiPen. These two actions impact consumers by increasing the supply of lifesaving EpiPens.

Another well-known agency is the Federal Trade Commission (FTC). The FTC was formed in 1914 when President Woodrow Wilson signed the Federal Trade Commission Act into law. The goal of the agency is to protect the consumer, encourage business competition, and further the interests of consumers by encouraging innovation. The FTC works within the United States as well as internationally to protect consumers and encourage competition. The agency fulfills this role by developing policies, partnering with law enforcement to ensure consumer protection, and helping to ensure that markets are open and free. For instance, management and enforcement of the Do Not Call List is part of the FTC's consumer protection goals.

The FTC protects consumers from unfair or misleading practices. Phone scams are a common issue. Scammers go to great lengths to trick the public into donating to false charities, providing personal information, or giving access to financial information. The FTC is aware of these issues and has put rules in place to punish scammers and educate the public. The FTC created a phone scammer reporting process to help collect information about scammers so that they can be prosecuted. The agency also collects information about scammers and creates educational materials for the public. These materials are designed to help consumers identify possible phone scammers, avoid their tactics, and report their activities.

A complete list of U.S. government agencies can be found at https://www.usa.gov/federal-agencies/a (https://www.usa.gov/federal-agencies/a) .

## 10.2 Regulatory Agencies

The power of administrative agencies comes from the executive branch of the government. Congress passes laws to carry out specific **directives**. The passing of these laws often creates a need for a government agency that will implement and carry out these laws. The government is not able to perform the work itself or manage the employees who will do the work. Instead, it creates agencies to do this. Assigning this authority to agencies is called **delegation**. The agencies have focus and expertise in their specific area of authority. However, it is important to note that Congress gives these agencies just enough power to fulfill their responsibilities.

Although administrative agencies are created by Congress, most administrative agencies are part of the executive branch of the government. The executive branch of government of the United States is headed by the president of the United States. Administrative agencies are created to enforce and administer laws, and the executive branch was created to oversee administrative agencies. Administrative agencies conduct exams and investigations of the entities they regulate. As a result of being part of the executive branch of government, the leaders of administrative agencies are generally appointed by the executive branch.

**Figure 10.5** Most administrative agencies are housed in the executive branch. The president of the United States appoints leaders to administrative agencies. (Credit: Aaron Kittredge/ pexels/ License: CC0)

Administrative agencies also have responsibilities that mirror the responsibilities of the judicial branch of government. Administrative law judges (ALJ) have two primary duties. First, they oversee procedural aspects, like depositions of witnesses related to a case. They have the ability to review rules and statutes and review decisions related to their agencies. They also determine the facts and then make a judgment related to whether or not the agency’s rules were broken. They act like a trial judge in a court, but their jurisdiction is limited to evaluating if rules established by certain government agencies were violated. They can award money, other benefits, and punish those found guilty of violating the rules.

## Federal Agencies

Well-known federal agencies include the Federal Bureau of Investigations (FBI), Environmental Protection Agency (EPA), Food and Drug Administration (FDA), Federal Trade Commission (FTC), Federal Election Commission (FEC), and the National Labor Relations Board (NLRB). These agencies were created to serve specific purposes. For instance, the FBI was created to investigate federal crimes. A federal crime is one that violates federal criminal law, rather than a state's criminal law. The EPA was created to combine federal functions that were instituted protect the environment. The NLRB was created to carry out the National Labor Relations Act of 1935.

The goal of federal agencies is to protect the public. The EPA was created in response to concerns about the dumping of toxic chemicals in waterways and about air pollution. It began when the Cuyahoga River in Ohio burst into flames without warning. President Richard Nixon presented a plan to reduce pollution from cars, end the dumping of pollutants into waterways, tax businesses for some environmentally unfriendly practices, and reduce pollution in other ways. The EPA was created by Congress in response to these environmental concerns and President Richard Nixon's plan. It is given the authority and responsibility to protect the environment from businesses, so that the people can enjoy a clean and safe environment.

As mentioned in the previous section, the Federal Trade Commission (FTC) was created to protect the consumer. It investigates and addresses activities that limit competition between businesses. The organization enforces **antitrust laws** that prevent one organization from restraining competition or seeking to maintain full control over a market. In December of 2006, the FTC ruled on the merger of America Online, Inc. (AOL) and Time Warner, Inc. The FTC decided that the joining of these two companies would limit the ability of other organizations to compete in the cable internet marketplace. The FTC ordered the merged company, AOL Time Warner, to do certain things that permitted competitors to engage, including opening its system to competitors' internet services and not interfering with the transmission signal being passed through the system. Doing so prevented the large company from shutting out its competitors. These are just a few examples of administrative agencies that were created to protect the community from business activities that could negatively impact the environment or the consumer.

**Figure 10.6** Although administrative agencies have a great deal of power, they are bound by the concept of due process at is described in the U.S. Constitution. (Credit: wynpnt/ pixabay/ License: CC0)

## Agency Structure

Administrative agencies are made up of experts, and they are trusted by Congress to identify the agency structure that best serves their specific goals. Thus, each agency is structured differently.

The FTC is a well-known agency and is organized into bureaus. Each bureau is focused on an agency goal. The three bureaus are consumer protection, competition, and economics. The Bureau of Consumer Protection focuses on unfair and deceptive business practices by encouraging consumers to voice complaints, investigate, and file lawsuits against companies. It also develops rules to maintain fair practices and educates consumers and businesses about rights and responsibilities. The Bureau of Competition focuses on antitrust laws and, by doing so, supports lower prices and choices for the consumer. And, lastly, the Bureau of Economics concentrates on consumer protection investigation, rulemaking, and the economic impact of government regulations on businesses and consumers.

## Administrative Procedure Act (APA)

These agencies are not unrestrained in their operations. First, there are due process requirements created in the Constitution. Rules must be reasonable and based on facts. Second, rules cannot violate anyone's constitutional rights or civil liberties. Third, there must be an opportunity for the public to voice its support, or lack of support, for a rule. In 1946, the **Administrative Procedure Act (APA)** was enacted. Under the APA, agencies must follow certain procedures to make their rules enforceable statutes. The Act set up a full system for the execution of administrative law by administrative agencies for the federal government. Although agencies have power, government agencies must still act within the structures in place, including the Constitution, span of authority, statutory limitations, and other restrictions. The APA outlines roles, powers, and procedures of agencies. It organizes administrative functions into rulemaking and adjudication.

## Assessment Questions

**1.** What is administrative law?

**2.** Administrative agencies are created by:
a. The president.
b. The judicial branch.
c. The Constitution.
d. Congress.

**3.** The FDA stands for:
a. The First Drug Administration.
b. The Federal Drug Administration.
c. The Food and Drug Administration.
d. The Food and Diet Administration.

**4.** Explain the goal of the Federal Trade Commission.

**5.** How does the FDA fulfill its role?

**6.** Who appoints leaders to run administrative agencies?
a. The President.
b. Congress.
c. The judges.
d. None of these are correct.

**7.** The process of assigning authority to administrative agencies is called:
a. An assignment.
b. A directive.
c. A passing.
d. A delegation.

**8.** What's the role of an Administrative Law Judge (ALJ)?

**9.** The Bureau of Economics concentrates on all but the following:
a. Consumer protection investigation.
b. Rulemaking.
c. Lower prices for consumers.
d. Economic impact of government regulation.

**10.** Explain the purpose of the Administrative Procedure Act ("APA").

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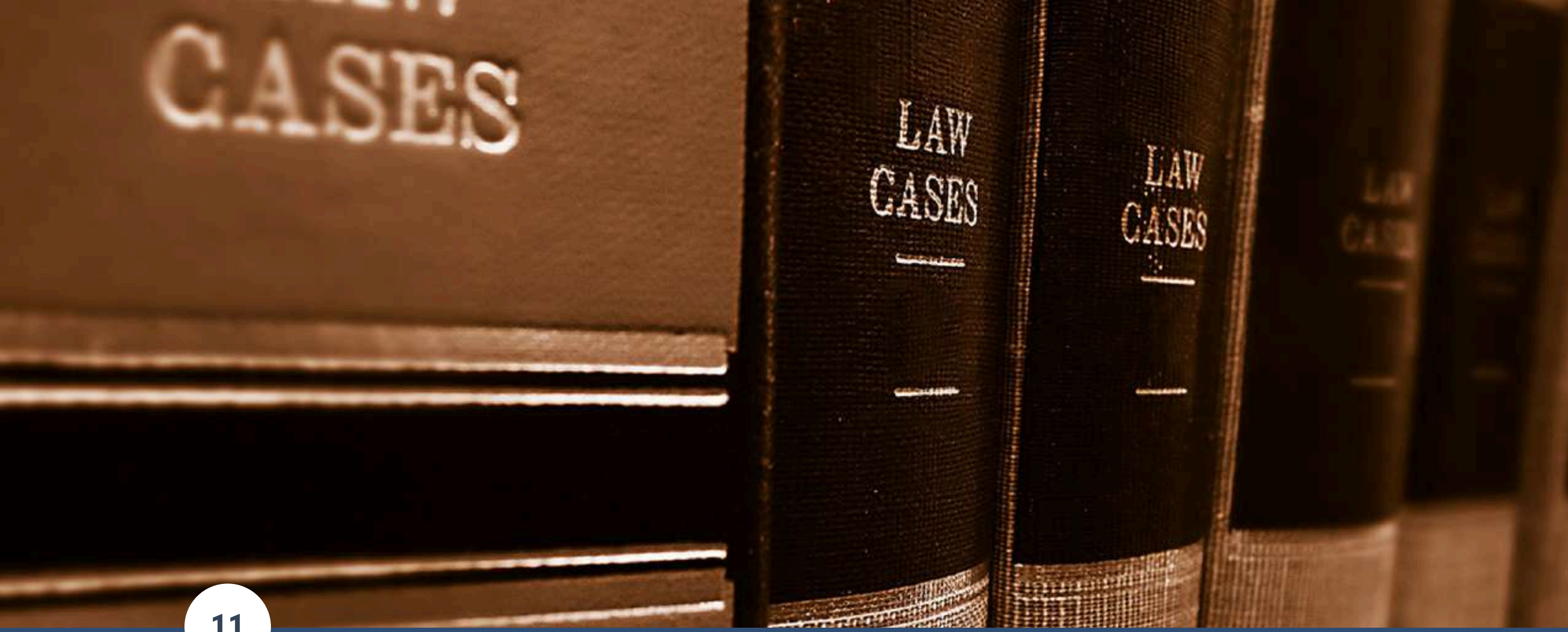


# 11 Antitrust Law

**Figure 11.1** (Credit: witwiccan/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

## Chapter Outline

**11.1** History of Antitrust Law
**11.2** Antitrust Laws

## Introduction

### Learning Outcome

- Analyze the tenets of antitrust laws in the United States.

## 11.1 History of Antitrust Law

What if the two largest manufacturers of soft drinks, Coca Cola Co. and PepsiCo, merged? It is likely that the mega-company that resulted would dominate the soft drink industry, squeezing out all of the other smaller competitors.

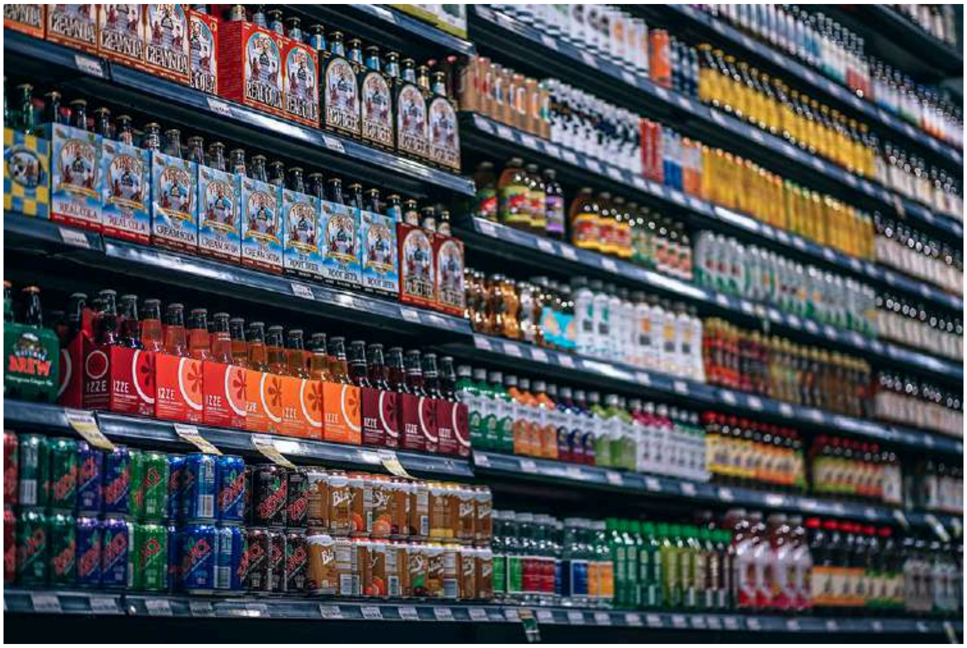

**Figure 11.2** Without antitrust laws, the shelves would have fewer products for consumers to choose from. Image: Beverages, Bottles, Shelf. (Credit: igorovsyannyko/ pixabay/ License: CC0)

In the late 1800s, concern over this kind of merger, as well as other attempts by large companies to create monopolies or to control the market, led state and federal lawmakers to take steps to reduce the risks associated with this type of practice.

## Business Trusts

During the late 1800s, the United States became concerned about the development of corporate monopolies dominating the manufacturing and mining industries (Jurist, n.d.). The end of the Civil War marked the beginning of large advances in industrialization. Many large companies formed, especially in the oil and steel industries, which were two industries that the country was beginning to heavily rely on. Manufacturing and distributing companies grew at a fast pace in a wide variety of industries, ranging from sugar to beef to tobacco (West, n.d.). The problem was that the growth occurred so rapidly that supply exceeded demand. This outcome increased competition, and many companies sought to reduce the number of competitors through forms of **restraint of trade** such as price-fixing, monopolies, and mergers (West, n.d.).

**Figure 11.3** The oil industry expanded quicker than demand, causing companies to try to remove competition. (Credit: 15299/ pixabay/ License: CC0)

Some of the competitors were larger and more powerful than others, and they sought to limit the competition in the market by taking steps to reduce the number of smaller companies who were trying to compete with them (Federal Trade Commission, n.d.). Some of the larger companies banded together to create **business trusts**. A business trust is a trust agreement that allows businesses to maintain profits as beneficiaries, but legal ownership and management of the company’s property is maintained through the power of trustees (West, n.d.). These trusts allowed businesses that were members of the trust to grow larger, as they cooperated with one another and shut out other competitors (West, n.d.).

## Unfair Business Practices

Companies tried to create situations that would drive some competitors out of business while solidifying their own share of the market. This effort resulted in mergers and consolidation practices that placed the largest share of the industries under the control of just a few, thereby increasing their power. Since the trusts were able to fix prices and could afford to take some losses, they would drive prices down until competitors were forced out of business because they could not afford to operate at the lower rates (West. n.d.).

The markets began to consolidate under just a few companies because the smaller competitors continued to go out of business. The smaller competitors could not compete with the pricing and other practices that the trusts allowed the cooperative businesses to maintain. This design restricted free trade practices for both businesses and consumers. The few businesses in the trust, in turn, became more powerful, thus prompting the government to look for measures to control the situation (Federal Trade Commission, n.d.). The government determined that laws needed to be created to prevent this form of trade restriction.

## Rule of Reason

Unfair business practices did not reside solely with business trusts. Issues also occurred in agreements between competitors, contracts entered into between sellers and buyers, and practices that created or maintained cartels, monopolies, and mergers (West, n.d.). There were no specific laws that regulated these practices, so the courts were not entirely sure how to deal with them. Initially, courts seemed to swing both ways, both accepting and condemning certain forms of restraint of trade. Rulings were not consistent from state to state, and guidelines needed to be established. The guiding condition seemed to be whether or not the restraints prevented other merchants from entering the market (West, n.d.).

The courts used the **rule of reason** as the standard. The rule of reason explored the goal of the contract, which was considered either naked restraint or ancillary restraint. **Naked restraint** occurs as contracts promote a general restraint of competition. If the restraint was created with a goal of long-term impact without boundaries, it was considered to be a naked restraint (West, nd.). **Ancillary restraint** occurs as the restriction is limited in time and geography (West, n.d.). With ancillary restraint, the restraint would be short-term and limited in scope. The courts tended to frown upon naked restraint, but were less consistent with ancillary restraint. Initially, there did not seem to be a comprehensive common law applied similarly from state to state (West, n.d.). This problem was concerning enough to warrant a solution, and in 1890, the first antitrust law was enacted (Jurist, n.d.).

## Antitrust Laws

**Antitrust laws** regulate economic competition in an effort to maintain fair trade practices (West, n.d.). They were created to prevent the restraints on trade created by trusts and other large company practices. These restraints often resulted in price-fixing, control of production, and control of geographical markets (Jurist, n.d.). Many states recognized these outcomes as a threat to fair business practices. The federal government also recognized this issue and developed antitrust laws in 1887 as a result of a Standard Oil trust that was formed. The Standard Oil Trust occurred as oil companies transferred their stocks to a trustee to create a more powerful block of oil companies that prevented other oil companies from effectively competing with them (West, n.d.).

The first antitrust law created was the Sherman Antitrust Act in 1890, which became the basis for subsequent antitrust laws (Jurist, 2013). The Sherman Act was a good start, but it was not comprehensive enough to prevent trusts, and large companies continued to exert strong control over industries. At the turn of the century, a few large companies controlled almost half of all of the nation’s manufacturing assets (West, n.d.). It became evident that more legislation was necessary. President Theodore Roosevelt dubbed himself a “trustbuster,” and he began a campaign to create more effective legal endeavors (West, n.d.). Additional antitrust acts were passed in 1914, including the Clayton Act and the Federal Trade Commission Act. These acts are still in effect, and since 1914, they have been amended by Congress to continue to expand upon and solidify the coverage. It is estimated that antitrust laws save consumers millions of dollars a year, as they prohibit business practices that unfairly raise prices on goods and services (United States Department of Justice, n.d.).

## Conclusion

The original purpose of antitrust legislation, i.e., to foster competition that results in lower prices, more products, and more equal distribution of wealth between producers, remains relevant today (West, n.d.). Yet, large companies still seek advantages in trade and work to put competitors out of business. It is important to maintain unrestrained trade and prevent the few from having too much power over the many.

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# 11.2 Antitrust Laws

Antitrust legislation was designed to prevent unfair restrictions on trade and to maintain equal opportunity for trade for businesses and consumers alike. Throughout the history of antitrust laws, legislation has become more comprehensive and structured to keep up with the business practices of larger corporations that continue to seek advantages and control through trade practices.

## What Do Antitrust Laws Do?

Antitrust laws were created to prevent unlawful mergers and business practices that could lead to restraint of trade by others (Federal Trade Commission, n.d.). The laws themselves are somewhat general to allow the courts the ability to make decisions on these practices, based on changing times and markets (Federal Trade Commission, n.d.). The three main antitrust laws that are in effect have been in effect for over 100 years and through many changes in society—from an industrial age to a technological age, and the changing markets they represent. The federal government created and enforces these three main antitrust laws:

- The Sherman Antitrust Act
- The Clayton Act
- The Federal Trade Commission Act

Each state has its own antitrust laws that pertain to trade practices within each separate state, but federal laws are able to reach beyond the states to interstate trade.

## The Sherman Antitrust Act

The Sherman Act was passed in 1890 and focused on trade restraints that were considered unreasonable (Federal Trade Commission, n.d.). This Act did not prohibit all forms of trade restraint, since the courts did not see temporary limited restraints as an issue at the time. A partnership agreement that limited trade to certain areas for certain partners was considered acceptable. The courts deemed some trade restrictions as unreasonable, such as price fixing (Federal Trade Commission, n.d.). In some cases, the violation was so apparent that the violation was considered **prima facie**, or so evident that it automatically satisfied the unreasonable standard (Jurist, 2013).

The Sherman Act prohibits all contracts and interactions that unreasonably restrain foreign trade and trade between states (United States Department of Justice, n.d.). This prohibition does not mean that companies cannot lower prices on goods in an effort to outsell the competition. Doing so would be considered fair competition and trade. However, when a company is able to suppress the ability of others to compete through some intentional unfair business practice, such as forming agreements with competitors to set prices, it is considered a violation.

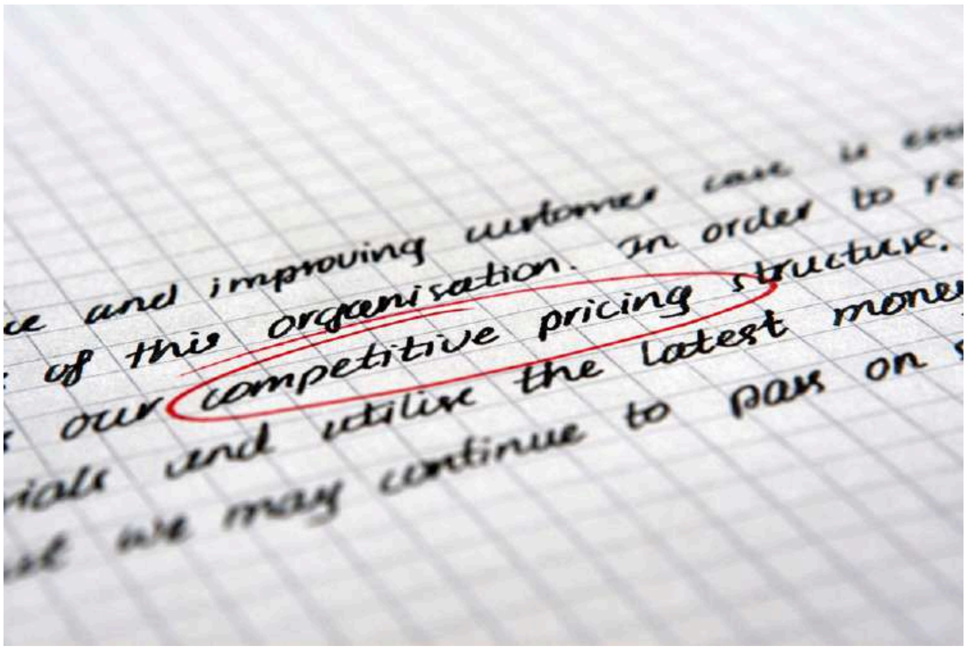


**Figure 11.4** Competitive pricing is a normal part of business until it involves unfair trade practices. (Credit: pixabay/ pexels/ CC0)

The Act is a criminal statute, meaning that violation of this Act would result in criminal penalties. Mergers or other actions that would create agreements to fix prices or bids or allocate customers are considered criminal felonies (The United States Department of Justice, n.d.). Violations of the Sherman Act could lead to penalties of up to $100 million for larger corporations and up to $1 million for individuals (Federal Trade Commission, n.d.). Those convicted could also face up to 10 years in prison. If the amount gained by the conspirators, or the amount lost by the victims of the crime, is over $100 million, the fine could be increased to twice the amount gained by the conspirators or lost by the victims—whichever is greater (Federal Trade Commission, n.d.).

The Sherman Act did have limitations. It did not provide clear and specific language, which left the courts to make decisions on a case-by-case basis, without any consistent **precedent** on which to rely (West, n.d.). Precedent occurs as courts make rulings in certain cases, and those rulings are followed in subsequent cases. This lack of precedent left many larger companies in control of their restraint of trade practices, and new legislation seemed necessary.

## The Clayton Act

The Clayton Act was passed in 1914. The Clayton Act is a civil statute rather than a criminal statute, meaning that it carries civil penalties rather than prison sentences (United States Department of Justice, n.d.). It primarily focuses on unfair mergers and acquisitions (Jurist, 2013). This Act sought to create more specific language to help the courts reduce unfair trade practices. As such, it established four acts as illegal, but not criminal, meaning that they would be tried as civil matters. The four acts are (West, n.d.):

- Price discrimination, which occurs as the same product is sold to different buyers at different prices
- Exclusive dealing contracts, which require buyers to purchase only from one business and not competitors
- Corporate mergers, which result in the acquisition of competing companies
- Interlocking directorates, which are boards of competing companies with common members sitting on each of the boards

The four acts would only be considered illegal when they create monopolies or substantially lessen competition (West, n.d.). Unions were excluded from mention in the Clayton Act, as Congress did not wish to treat human labor as a commodity (West, n.d.). This Act was still broad enough to rely on the courts for interpretation and decisions on a case-by-case basis.

The Clayton Act was amended in 1976 to require companies planning larger mergers and acquisitions to notify the government in advance and seek authorization (Federal Trade Commission, n.d.). This amendment also provides individuals who are victims of these practices with the ability to sue for triple damages after harm is established (Federal Trade Commission, n.d.).

## The Federal Trade Commission Act

The Federal Trade Commission Act (FTC Act), also passed in 1914, focuses on unfair methods of competition and deceptive acts or practices that impact commerce (West, n.d.). All acts that violate the Sherman Act also violate the FTC Act (Federal Trade Commission, n.d.). The FTC Act works to fill in the gaps of the unfair practices by condemning all anticompetitive behaviors not otherwise covered in the other federal antitrust laws (West, n.d.).


**Figure 11.5** The Federal Trade Commission was created to oversee fair trade practices. (Credit: Clker-Free-Vector-Images/ pixabay/ License: CC0)

The FTC Act is only enforceable by the Federal Trade Commission (FTC), which was created as a result of this Act (Jurist, 2013). The FTC implements the Act's provisions, and the FTC and the U.S. Department of Justice (DOJ) are the federal agencies responsible for prosecuting violators in either civil or criminal proceedings, depending on the act violated. One remedy that the FTC or DOJ can seek is **divestiture**, which forces the company to give up one or more of its operating functions (West, n.d.). Another remedy is **dissolution**, which would terminate the right of a partnership to exist (West, n.d.).

## Exemptions

There are limitations on antitrust laws that have been introduced over the years. These include:

- Labor – A labor union can organize and bargain within the bounds of antitrust laws, as long as it does not combine with a nonlabor group.
- Agriculture and Fisheries – Collective co-ops of agricultural groups or fisheries can form, as long as they do not engage in restraint of trade.
- Foreign Trade – Companies can join forces in cooperative activities involving foreign trade exports, as long as trade within the United States is not restrained.
- Cooperative Research and Production – Small businesses can cooperatively work together on research

joint ventures.

In essence, exemptions are allowed, as long as they do not act to restrain trade in the United States (West, n.d.). Once restraint of trade becomes a factor, the practices are no longer exemptions and are subject to antitrust laws.

## Conclusion

The three main antitrust laws, namely the Sherman Act, the Clayton Act, and the Federal Trade Commission Act, all work to prevent unfair trade practices that can substantially harm free competition. They also work to protect consumers from practices that would control pricing or the ability to buy or engage in services. They prevent companies from taking actions that would allow them to become too big or too powerful, thus controlling how, and what, consumers and other businesses can do.

## Assessment Questions

**1.** All of the following are forms of restraint of trade that company might use to reduce competition except:

a. Monopolies.
b. Oversupply.
c. Price-fixing.
d. Mergers.

**2.** What is a Business Trust?

**3.** Distinguish between naked restraint and ancillary restraint.

**4.** What was the first antitrust law enacted?.

a. The Clayton Act.
b. The Federal Trade Commission Act.
c. The Antitrust Act.
d. The Sherman Act.

**5.** What was the original purpose of antitrust legislation?

**6.** What recourse does the FTC have if an individual or company engages in an unfair trade practice?

a. Consent order.
b. Administrative complaint.
c. Litigation.
d. All of the above.

**7.** Each state has its own Antitrust law.

a. True.
b. Fasle.

**8.** Which of the following is not prohibited by the Sherman Act?

a. Temporary limited restraints.
b. Temporary restraints.
c. Naked restraints.
d. Ancillary restraints.

**9.** Which of the following are possible penalties for violation of the Sherman Act?

a. Up to $100 million for corporations and individuals.
b. Up to $100 million for individuals.
c. Up to $100 millions for corporations.
d. None of these are correct.

**10.** Which of the following are considered illegal by the Clayton Act?

a. Price discrimination.
b. Exclusive dealing contracts.
c. Corporate mergers.
d. All of the above.

**11.** The following are exempt from antitrust laws:

a. Small businesses.
b. Coops.
c. Labor unions.
d. Agriculture groups even if they engage in restraint of trade.

**12.** When was the Federal Trade Commission established?

a. 1912.
b. 1914.
c. 1916.
d. 1920.

**13.** The following are bureaus of the Federal Trade Commission except:

a. Bureau of Unfair Trade Practices.
b. Bureau of Consumer Protection.
c. Bureau of Competition.
d. Bureau Economics.

**14.** What is the mission of the Bureau of Competition?

**15.** Explain the Wheeler-Lea Act.

## Endnotes

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12

# Unfair Trade Practices and the Federal Trade Commission

**Figure 12.1** (Credit: Carol M. Highsmith collection/ wikimedia/ Attribution 2.0 Generic (CC BY 2.0))

## Chapter Outline


**12.1** Unfair Trade Practices
**12.2** The Federal Trade Commission


## Introduction

### Learning Outcomes

- Analyze laws pertaining to unfair trade practices and the agency that scrutinizes them.

## 12.1 Unfair Trade Practices

The term “unfair trade practice” describes the use of deceptive, fraudulent, or unethical methods to gain business advantage or to cause injury to a consumer. Unfair trade practices are considered unlawful under the Consumer Protection Act. The purpose of the law is to ensure that consumers have the opportunity to make informed, rational decisions about the goods and services they purchase.

Unfair trade practices include false representation of a good or service, targeting vulnerable populations, false advertising, tied selling, false free prize or gift offers, false or deceptive pricing, and non-compliance with manufacturing standards. Alternative names for unfair trade practices are “deceptive trade practices” or “unfair business practices.”

Section 5(a) (https://www.federalreserve.gov/boarddocs/supmanual/cch/ftca.pdf) of the Federal Trade Commission Act prohibits “unfair or deceptive acts or practices in or affecting commerce.” Per the rule, unfair practices are those that cause, or are likely to cause, injury to consumers, those that consumers cannot avoid, and those in which the benefits of the product or service do not outweigh the deception. Deceptive practices are defined as those in which the seller misrepresents or misleads the consumer, and the misleading practice is substantial.

The Federal Trade Commission (FTC) is a federal agency that enforces consumer protection laws. Consumers may seek recourse for unfair trade practices by suing for compensatory or punitive damages. Plaintiffs do not have to prove intent. Showing that the practice itself was unfair or deceptive is sufficient.


**Figure 12.2** The Federal Trade Commission (FTC) enforces consumer protection laws. (Credit: U.S. Government/ wikimedia/ License: Public Domain)

## Unfair Trade Practices and Examples

### Product Guarantees and False Endorsements

Companies must be prepared to honor product guarantees. For example, if a product is advertised with a 50 percent money-back guarantee, then that must be provided to customers who meet the requirement(s) attached to the guarantee. Similarly, companies may not create false endorsements and testimonials about their products.

### Unfair Advertising

False advertising includes the misrepresentation of a product, service, or price. It may be more expansively defined to include unfair sales strategies, such as advertising one item and then selling another item in its place, e.g., one that is higher priced, lower quality and/or less in demand. This method is most commonly referred to as “bait and switch.” Additional examples of unfair advertising include incorrect pricing, fake endorsements, deceptive guarantees, making false statements, and providing descriptions that exaggerate the performance of the product or service.

### EXAMPLE 12.1

For months, Ivan had searched for just the right window curtain to match the décor of his new high rise condo. Finally, while browsing through Amazon, he saw two gray velvet curtains that featured a damask pattern, with taupe and gold accents and specks of ice blue glitter accents. He could not have designed a more perfect color palette for the window treatments if he tried. Moreover, the velvet blackout touch was just what he needed. Excited, he hit the “Buy Now” button and waited a couple of days for his order to arrive. When it did, what a huge disappointment! He could see, if he stared long and hard enough, how someone with a vivid imagination might consider the curtain to be an abstract interpretation of what was advertised. However, most people would see that the product was not at all close to what was advertised. The velvet was closer to linen, the damask pattern was closer to swirls, and the taupe and gold accents with specks of ice blue were closer to silver and purple, with specks of mauve. After running a Google reverse image search of the original product photo, he saw it featured in an interior design magazine. When Ivan looked up the product endorsements and reviews, he saw that all of the reviewers had only posted reviews for that particular seller’s products, and that they had posted nothing but glowing reviews for each of the products. It was clear to Ivan that the seller was guilty of false advertising, as well as faking endorsements. Ivan has enough information to submit a consumer complaint to the Federal Trade Commission.

## Taking Advantage of Customers

The FTC also pays particular attention to business ventures that target vulnerable populations. For example, some telemarketing efforts employ intense pressuring tactics to target seniors and people who don’t speak English.

### EXAMPLE 12.2

Devin is involved in the telemarketing of spy gadgets, such as bugs and bug detectors. He has had a lot of trouble finding a market for these products. One day, he speaks with an older citizen who asks him about the benefits of the bug detector. Devin starts to knowingly make unsubstantiated claims that there have been news reports that home bugging is on the rise. His false claims works like a charm. Spooked, the elderly customer buys the most expensive bug detector product. Seeing his success, Devin purchases a report of households in his geographic selling area that are headed by people over the age of 70. Over the next few months, his sales increase at an explosive rate. When he is recognized by management for his leading sales numbers, they also inquire about the secret to his success as they seek to replicate it in training materials for other sales professionals. When Devin proudly explains his tactics, he is terminated by the company. The company calls the customers impacted by his false claims, explains that there was a misrepresentation by one their sales associates regarding the scope of known bugging activity, allows them to keep their bug detectors, and refunds them the money they spent purchasing the products. The sales associate engaged in unfair trade practices, but the company took appropriate steps to correct it.

### Misrepresenting a Product

At times, the FTC may be quite technical in its definition of certain terms. For this reason, companies should be very clear about their usage of various phrases and words. For example, the word “new” may only be used to refer to a product that is less than six months old. Other terms may be the subject of debate or litigation, such as whether a lotion will actually “rejuvenate” skin or whether a tablet will actually “cure” baldness. Indeed, a sweater should not be called “wool” unless that is its complete composition. There are many examples, so it is important for businesses to have an understanding of the FTC’s rules on this topic.

### Giving Misleading Price Information

The FTC sanctions misleading price information as an unfair trade practice. Examples of misleading price information include false sales in which a “limited time offer” might actually be available forever, or running a “Going Out of Business” sale without any plans to go out of business while advertising that items are discounted, although the prices have not changed.

#### EXAMPLE 12.3

A brick and mortar store has an online promotion for a “buy one, get one” offer for the season’s hottest new phone, stating that the offer is only available on Black Friday. The store opens at 5:00 a.m., and customers start lining up with their sleeping bags in tow the evening prior to the morning opening time. After customers almost stampede one another, they learn that they will have to also purchase a phone plan that is inflated by 100% of its regular price to qualify for the deal. Nowhere in the literature or promotions was the phone plan, or its over-inflated price, mentioned as a requirement to get the buy one get one free phone deal.

### Failing to Disclose Pertinent Information

Merchants must disclose facts that would reasonably influence the consumer’s decision to make a purchase. Withholding pertinent information from customers may be viewed by the FTC as equal in severity to the process of using overtly incorrect or deceptive information. For example, sellers should always disclose the full price of their products or services before accepting payment for them.

## 12.2 The Federal Trade Commission

The FTC was created in 1914 to address the problem of monopolies and trusts. Following the Civil War, a wave of consolidation and growth among companies triggered increased public debate. Through handshake agreements, issuance of stock, and pooling arrangements, companies could fix prices and outputs, thus effectively stopping competition and raising consumer prices. A substantial number of mergers gave control over key industries to small groups of businesses. Where companies did not merge, other arrangements were made to have a similar effect. Conglomerates controlled most of the relevant industries that produced household necessities. Goods used in production were also the product of highly concentrated trusts, such as the United States Steel Corporation and the International Paper Company. Concerns about industrialization and a changing economy, with shifting norms for personal lives, triggered antitrust sentiment.

**Figure 12.3** The Federal Trade Commission prevents monopolies, like that of U.S. Steel in the early 20th century. (Credit: Bruce McAllister/ wikimedia/ License: Public Domain)

The perceived unfairness and fears caused by the consolidation of businesses created strong anti-business sentiment and increasing cries for price controls to be considered as a remedy for heavily concentrated industries. These organizations posed economic and social problems that became a large social concern. In response, the Federal Trade Commission (FTC) was created with broad powers to investigate and propose formal recommendations to companies about their competitive practices. The FTC did not formally have a consumer protection mission until the passage of the Wheeler-Lea Act in 1938. This act gave the FTC the power to combat false advertising for any foods, drugs, medical devices, or cosmetics.

In addition to the Wheeler-Lea Act, subsequent amendments to the FTC Act, as well as judicial respect toward the agency, broadened the power and jurisdiction of the FTC.

Today, in addition to its original antitrust roots, the FTC enforces consumer protection laws.

## Bureaus of the FTC

Several bureaus now stand in support of the FTC’s efforts.

### Bureau of Consumer Protection

The Bureau of Consumer Protection protects consumers against unfair trade practices. Bureau attorneys enforce consumer protection laws issued by the FTC. In addition to enforcement actions, the Bureau’s functions include investigations and consumer and business training. Unfair trade practices in advertising and marketing are a main focus, as well as privacy, financial products and practices, and identity protection. The Bureau also manages the United States National Do Not Call Registry and investigates telemarketing fraud.

### Bureau of Competition

The Bureau of Competition's purpose is to eliminate and prevent "anticompetitive" business practices related to the enforcement of antitrust laws. The FTC and the Department of Justice share responsibility for enforcement of antitrust laws.

### Bureau of Economics

The Bureau of Economics supports the Bureau of Competition and Bureau of Consumer Protection by providing subject matter expertise regarding the economic impacts of FTC legislative activity.

## FTC Activities

The FTC investigates issues raised through a number of sources, including consumer, business, and media reports. If the FTC concludes that there was unlawful conduct, it may seek several forms of recourse. These include the pursuit of voluntary compliance through a consent order, the submission and filing of administrative complaints, or the initiation of a federal action and litigation.

The FTC has the power to create rules regarding widespread industry practices. Rules created in this fashion to address systemic issues are called trade rules.

## Assessment Questions

**1.** Define unfair trade practices.

**2.** All of the following are considered unfair trade practices except:

a. Targeting vulnerable populations.
b. Charging extremely high prices.
c. False advertising.
d. False representation of a good or service.

**3.** What is a bait and switch?

**4.** Describe the role of the Federal Trade Commission.

**5.** The following are examples of a company giving misleading price information except:

a. Advertising "Limited Time Offer" when the offer is available forever.
b. Advertising "Going Out of Business" when the company plans to stay in business.
c. Advertising the product as "New" when the product is more than 6 months old.
d. Advertising "Buy One, Get One" without informing consumers that they must buy another product or service to get the deal.

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13

# International Law

**Figure 13.1** (Credit: geralt/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

## Chapter Outline

**13.1** Introduction to International Law
**13.2** Sources and Practice of International Law

## Introduction

### Learning Outcome

- Explain international law and its role in business.

## 13.1 Introduction to International Law

In 1945, President Harry Truman stated, “When Kansas and Colorado have a quarrel over the water in the Arkansas River they don’t call out the National Guard in each state and go to war over it. They bring a suit in the Supreme Court of the United States and abide by the decision. There isn’t a reason in the world why we cannot do that internationally” (Cheeseman, 2016, p. 903). Customs, which vary among global communities and international organizations, are a primary reason why the world cannot pursue such an answer to trade and commerce dealings. The priorities and aims for Chinese businesses differ from those of Brazil. Each of those two countries have radically different business perspectives from the United States. For this reason, international law utilizes customs, treaties, and organizations to guide relationships among nations, with the goal of allowing each country as much leverage as possible over its own business dealings.

**Figure 13.2** International laws are based on customs, treaties, and organizations that guide partnerships among nations. (Credit: GDJ/ pixabay/ License: CC0)

## International Law

**International law** relates to the policies and procedures that govern relationships among nations (Clarkson, Miller, & Cross, 2018). These are crucial for businesses for multiple reasons. First, there is not a single authoritative legislative source for global business affairs, nor a single world court responsible for interpreting international law (Cheeseman, 2016, p. 903). There is also not a global executive branch that enforces international law, which leaves global business affairs particularly vulnerable.

Secondly, if a nation violates an international law and persuasive tactics fail, then the countries that were violated, or international organizations tasked with overseeing global trade, may act. Often these actions use force to correct the offenses and may include economic sanctions, severance of diplomatic relations, boycotts, or even war against the offending nation (Clarkson, Miller, & Cross, 2018, p. 439).

The purpose of international laws is to permit countries as much authority as possible over their own international business affairs, while maximizing economic benefits of trade and working relationships with other nations. Since many countries have historically allowed governance by international agreements when conducting global business, there exists an evolving body of international laws that facilitate global trade and commerce.

## U.S. Constitutional Clauses

There are two important clauses in the U.S. Constitution related to international law. First, the **Foreign Commerce Clause** enables Congress to "regulate commerce with foreign nations" (Cheeseman, 2016, p. 904). This clause permits U.S. businesses to actively negotiate and implement taxes or other regulations as they relate to international commerce. However, businesses cannot unduly burden foreign commerce. For example, General Motors, which is based in Michigan, cannot suggest that the state impose a 50 percent tax on foreign-made automobiles sold in the state, while not imposing the same tax on U.S.-made vehicles. Michigan can, however, impose a 10 percent tax on all automobile sales in the state to offset the costs of foreign trade and commerce.

The second important clause related to international law is the **Treaty Clause**, which states that the president has the power "by and with the advice and consent of the senate" to create treaties with other nations (Clarkson, Miller, & Cross, 2018, p. 440). This clause restricts treaties to federal authority, meaning that states do not have the power to enter a treaty with another nation. For example, the United States and Mexico can sign a treaty to reduce trade barriers between both nations, but the state of Texas cannot sign a treaty with Mexico to reduce trade barriers between Texas businesses and Mexico. Additionally, any treaties established with other countries become U.S. law, and any conflicting law is null and void.

## Primary Sources of International Law

International customs, treaties, and organizations are the primary sources of international law (Clarkson, Miller, & Cross, 2018, p. 439).


**Figure 13.3** Three distinct components are sources for how international law is understood, defined, and interpreted around the world. (Modification of art by BNED Credit: CC BY NC SA)

These three components work together to guide how nations understand, define, and interpret international laws that govern global business affairs.

### International Customs

Customs are general practices between nations that guide their business relationships. According to the

Statute of the International Court of Justice, international customs are “accepted as law” (Clarkson, Miller, & Cross, 2018, p. 439). While customary international law (CIL) is not written, nor does it require ratification to become binding, CIL nonetheless provides guidelines for how nations conduct business affairs (Bradley & Gulati, 2010, p. 204). One example of a custom is the international protection of ambassadors. For thousands of years, ambassadors have been protected while serving diplomatic missions. For this reason, countries protect foreign ambassadors with the understanding that any harm caused to ambassadors would be a violation of international law.

### International Treaties

Treaties and other agreements between nations are authorized and ratified by the countries that acknowledge their legality. There are two different types of agreements: bilateral, which is formed by two nations; and multilateral, which is formed by several nations. The Peru-United States Trade Promotion Agreement is an example of a bilateral agreement. It was signed in 2006, ratified by Peru the same year, and ratified by the United States in 2007. This bilateral agreement is considered beneficial to the United States because it improves access to Peruvian goods, while promoting security and democracy in the South American country. The North American Free Trade Agreement, or NAFTA, is an example of a multilateral agreement. It was ratified in 1994, when Mexico joined the previous trade agreement between the United States and Canada. In September 2018, the Trump administration successfully completed re-negotiations with Mexico and Canada that lasted over one year. Among other aims, these negotiations worked to increase auto industry wages for workers in Mexico and modify pharmaceutical regulations with Canada.

### International Organizations

International organizations are comprised of officials who represent member nations that have established a treaty to oversee shared interests, including trade and commerce. The U.S. participates in more than 120 bilateral and multilateral organizations around the world. International organizations adopt resolutions that standardize behavior and create uniform rules related to trade and commerce. Two of the most significant international organizations established in the twentieth century that significantly impact U.S. trade and commerce are the United Nations and the European Union.

## United Nations

The **United Nations (UN)** was created as a multilateral treaty in 1945. The UN’s organizational goals include maintaining global peace and security, promoting economic and social cooperation, and protecting human rights, especially related to women and children (Cheeseman, 2016, p. 905). The UN **General Assembly** includes representatives from each member nation. As of 2018, the UN acknowledges 195 sovereign states, with all but two participating as full members. These two, Palestine and the Vatican City, are classified as “observer states.” Six additional countries are not UN members, but are recognized as a country by at least one UN member country: Abkhazia, Kosovo, Northern Cypress, South Ossetia, Taiwan, and Western Sahara.

The UN **Security Council** includes five permanent members and 10 countries selected by the General Assembly to serve two-year terms. The five countries that hold permanent membership are China, France, Russia, the United Kingdom, and the United States (Cheeseman, 2016, p. 558). This Council is primarily responsible for overseeing global peace and security measures. The World Bank is a UN organization, financed by contributions from developed countries and headquartered in Washington, D.C. Its primary functions include providing money to developing countries to fund projects that relieve suffering, including building roads and dams, establishing hospitals, developing agriculture, and other humanitarian efforts. The World Bank provides both grants and long-term low interest rate loans to countries, often granting debt relief for outstanding loans (Cheeseman, 2016, p. 559).

The United Nations Commission International Trade Law is one of the most important international organizations to date, establishing the 1980 Convention on Contracts for the International Sale of Goods (CISG), which will be discussed further in the next section.

### European Union

The **European Union (EU)** is a regional international organization that includes many countries in Europe. It was established to create peace across the region and promote economic, social, and cultural development (Cheeseman, 2016, p. 561). As of 2018, there are 28 countries affiliated with the EU, although the United Kingdom has begun steps to withdraw its membership. Additionally, Macedonia is actively seeking a path toward EU membership, although as of September 2018, the country's citizens remain divided. The EU organization has established a treaty for its members that creates open borders for trade among member nations, especially for capital, labor, goods, and services. The impact on U.S. commerce is significant, as the EU represents more than 500 million people and a gross community product that exceeds that of the United States, Canada, and Mexico combined (Cheeseman, 2016, p. 561).

### Sovereignty

National sovereignty defines a nation. While clearly defined borders and independent governments also set parameters for a nation, **sovereignty** is an important legal principle that allows nations to enter negotiated treaties with other countries and honor territorial boundaries. It is among the most important international law principles, thus greatly impacting international trade and commerce.

Since the 1800s, most established nations allowed for absolute sovereignty among the global community. However, by the 1940s, that allowance was significantly reduced, as countries revisited sovereignty in light of globalization, transportation, and communication advances, and the rise of international organizations (Goldsmith, 2000, p. 959). Consequentially, doctrines of limited immunity were created that established guidelines for how countries may prosecute, or hold foreign nationals accountable, during international trade and commerce dealings.

A **doctrine of sovereign immunity** states that countries are granted immunity from lawsuits in courts of other countries (p. 569). Although the United States initially granted absolute immunity to foreign governments from lawsuits in U.S. courts, in 1952, the United States adapted federal law to qualified immunity, which is the immunity regulation adopted in most Western nations. This law led to the **Foreign Sovereign Immunities Act of 1976**, allowing U.S. governance over lawsuits against other nations in the United States in either federal- or state-level courts. Simply stated, a foreign country is not immune to lawsuits in the United States when the country has waived its immunity, or if the commercial activity against which the lawsuit is intended causes a direct effect in the United States.

## 13.2 Sources and Practice of International Law

International law is primarily governed by customs, treaties, and organizations that influence how laws are understood, interpreted, and enforced around the world. Since there is not a central court to enforce international law, each country utilizes its own courts to settle disputes. Collective action, reciprocity, and shaming are three examples of non-legislative methods that influence trade when enacted against nations that violate international law.

**Figure 13.4** International laws are enforced through positive and punitive measures that seek to uphold the global integrity of trade and commerce among all nations. (Credit: qimono/ pixabay/ CC0)

## Sources of International Law

The sources of international law are customs, treaties, and organizations, as discussed in the previous section. These three components work synergistically to influence how the international community facilitates business trade and commerce. More importantly, international law is enforced when a country violates the principles set forth by globally shared customs, treaties, and organizations.

One of the most important governing documents for international law is the **United Nations Convention on Contracts for the International Sale of Goods (CISG)**, which was established in 1980. This law governs contracts of countries that have ratified it as the priority contract for trade. By January 2018, 84 countries had adopted CISG, including the countries that account for more than two-thirds of all global trade. Those countries include the United States, Canada, China, Japan, Mexico, Argentina, Brazil, and most European countries. The CISG is enforced whenever international transactions occur without the presence of written contracts to govern those transactions. There are limits to the CISG, however, as the CISG does not apply to consumer sales or contracts for services (Clarkson, Miller, & Cross, 2018, p. 376).

## International Principles and Doctrines

There are three significant principles that help establish and enforce international law: the Principle of Comity, the Act of State Doctrine, and the Doctrine of Sovereign Immunity.

The **Principle of Comity** states that nations will defer to the laws and decrees of other nations when those laws are consistent with their own, essentially upholding reciprocity between nations with similar laws. For example, a U.S. court will most likely uphold a business contract as valid even if it was drafted in England, since the United Kingdom’s legal procedures are consistent with U.S. procedures (Cross & Miller, 2018, p. 216).

The **Act of State Doctrine** is a law applicable in England and the United States. It states that these two nations will not pass legal judgement on public acts committed by a recognized government if those acts occur within that government's own territory (Cross & Miller, 2018, p. 216). For example, the United States will not file a lawsuit against Petrobras, a Brazilian oil company, alleging price fixing, since the act of pricing oil occurs in Brazil, which is a nation that holds control over its own natural resources.

The **Doctrine of Sovereign Immunity**, which was introduced in the previous section, states that foreign nations are immune from U.S. jurisdiction when certain circumstances are applied. However, there are exceptions to this law. If a foreign country conducts commercial business activity in the United States and an entity in the United States files a lawsuit against the foreign business, then the foreign state is not immune from U.S. jurisdiction (Cross & Miller, 2018, p. 216).

## International Law Enforcement

One of the most important considerations for international business is understanding that companies operating in foreign nations are subject to the laws of those nations (Cross & Miller, 2018, p. 212). When international laws are violated, disputes are often resolved through the legal systems within individual nations. Most countries have either common law or civil law systems. **Common law systems** operate independently by developing their own rules that govern areas of business law, such as torts and contracts. The United States has a common law system. One-third of all people in the world live in nations in which common law is practiced. **Civil law systems** base their legislation on Roman civil law, which utilizes statutory codes as the primary source of law (p. 212).

| Common Law | | Civil Law | |
|---|---|---|---|
| Australia | Malaysia | Argentina | Indonesia |
| Bangladesh | New Zealand | Austria | Iran |
| Canada | Nigeria | Brazil | Italy |
| Ghana | Singapore | Chile | Japan |
| India | United Kingdom | China | Mexico |
| Israel | United States | Egypt | Poland |
| Jamaica | Zambia | Finland | South Korea |
| Kenya | | France | Sweden |
| | | Germany | Tunisia |
| | | Greece | Venezuela |

**Table 13.1**

## Impact on International Trade

There are three international law enforcement methods that can radically impact trade: collective action, reciprocity, and shaming.

**Collective action** occurs when businesses work collectively to strengthen their resources and achieve a shared goal. In February 2018, the UN Conference on Trade and Development Secretary-General argued that collective action can be one of the most effective methods for protecting international trade in the current global climate. Due to recent trade restructuring from the United States and the United Kingdom (pending its withdrawal from the EU), collective action was promoted as a way to “harness energy that will not fragment the [international trade] system” (UNCTAD, 2018). By leveraging nations to defend “rules-based multilateral trading systems as a force for creating inclusive prosperity,” the Secretary-General promoted collective action as the primary way to assure continued international peace and economic viability for generations to come.

**Reciprocity** is central to international trade and at the core of CIL. It happens most commonly in international business exchanges as countries lower import duties, or other trade barriers, in exchange for mutual arrangements extended by the other country. Reciprocity can be beneficial to the nations involved, or it can be punitive. In 2016, presidential candidate Donald Trump campaigned for an international trade climate that would produce fairer options for the United States. Since his inauguration, he has increasingly pressured the global community by imposing taxes on imports from Canada, China, the EU, and Mexico, each of which has retaliated in reciprocity. In 2018, China accused the United States of launching the “largest trade war in economic history,” of which the final global impacts remain largely unknown (BBC, 2018).

**Shaming** is a deliberate attempt to negatively impact a state, regime, or governmental leader’s reputation by publicizing and targeting violations of international laws, including customary norms, treaty breaches, and violations of organizational expectations (Gopalan & Fuller, 2014, p. 75). However, shaming is not viewed as particularly effective without more concrete measures to accompany it (Klymak, 2017). A recent research study conducted by the Department of Economics in Dublin, Ireland, found that there is no evidence to suggest that there has been a decrease in the imports of goods to the United States from countries where foreign goods are likely produced by child and forced labor. Despite media coverage and the International Labour Organization’s coverage that routinely shames certain nations for producing goods by child or forced labor, those goods are nonetheless regularly imported for international sale.

## Assessment Questions

**1.** What is International law?

**2.** The following are clauses in the U.S. Constitution that relate to international law.

a. Treaty Clause.
b. Foreign Commerce Clause.
c. Both a and b.
d. Neither a nor b.

**3.** Explain the European Union.

**4.** What is the Doctrine of Sovereign Immunity?

**5.** The UN Security Council is made up of:

a. 5 members and 10 countries.
b. 10 members and 5 countries.
c. 10 members and 10 countries.
d. 5 members and 5 countries.

**6.** Sources of international law include:

a. Customs, treaties, and laws.
b. Customs, treaties, and edict.
c. Treaties, laws, and edicts.
d. Customs, treaties, and organizations.

**7.** Explain the principle of comity.

**8.** Compare and contrast common law systems vs. civil law systems.

**9.** How many countries have adopted the United Nations Convention on Contracts for the International Sale of Goods (CISG)?

a. 74.
b. 84.
c. 94.
d. 104.

**10.** All of the following are international law enforcement methods except:

a. Collective action.
b. Reciprocity.
c. Shaming.
d. All of the above.

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# 14 Securities Regulation

**Figure 14.1** (Credit: Sam Valadi/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

## Chapter Outline

**14.1** Liability Under the Securities Act
**14.2** The Framework of Securities Regulation

## Introduction

### Learning Outcome

- Describe the Securities Exchange Act of 1934 and its impact on business.

## 14.1 Liability Under the Securities Act

As explained in the previous section, many companies were initially irritated by the creation of the Securities Exchange Act of 1934, as it created a myriad of legal responsibilities and potential liabilities that impacted their business models. Companies came to recognize that they needed legal counsel and internal systems in place to ensure that they were in compliance. The liabilities for not complying with the Securities and Exchange Act of 1934 include not only monetary fines, but also **civil** penalties, and in some cases, **criminal** proceedings. Insider trading is one violation that can result in criminal charges.

### Insider Trading

While laws vary from country to country, **insider trading** can be understood by what the SEC defines as the "buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material, nonpublic information about the security." The word **fiduciary** comes from the Latin word for trust and refers to someone who is charged with the responsibility to act in the best interest of the other party. In the case of businesses, fiduciaries are expected to act in the best interests of their investors. However, they are often aware of information that the public is not. This knowledge has important implications as addressed by Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, which prohibits the purchase or sale of securities on the basis of "**material nonpublic information**,"; meaning information of any kind that would impact the market price of securities that has not been disclosed to the public, i.e., insider information. The directors, large shareholders, and officers of companies frequently have access to nonpublic information that could affect the future value of a security. While an individual, as opposed to an entire company, is often charged as an insider trader, such charges can affect the entire company’s reputation, putting it in a negative light and eroding investor trust.

One instance of insider trading that received widespread media attention involved Martha Stewart, who in 2003 became the subject of legal scrutiny after selling her shares in the pharmaceutical company ImClone. Following the advice of her broker, David Bacanovic, Stewart sold all of her shares of ImClone before it lost 16 percent of its value. Bacanovic represented ImClone CEO Sam Waksal, who was selling $5 million of his ImClone shares. While Bacanovic claimed he did not know why, he shared this information with Stewart. As it turned out, the FDA had not approved ImClone’s primary pharmaceutical product, Erbitux, which was a setback that only insiders were privy to. Stewart avoided a $45,673 loss by selling her shares before the public announcement. Even though Stewart may not have known exactly why ImClone would go down in value, the court decided that her decision to act upon her broker’s suggestion constituted a wrongdoing. Stewart’s role as a public figure was also relevant to this decision, as explained by SEC’s Director of Enforcement Stephen M. Cutler, who said, “It is fundamentally unfair for someone to have an edge on the market just because she has a stockbroker who is willing to break the rules and give her an illegal tip. It’s worse still when the individual engaging in the insider trading is the Chairman and CEO of a public company.”


**Figure 14.2** Insider trading can result in criminal conviction and possibly jail time. (Credit: Suzy Hazelwood/ pexels/ License: CC0)

Insider trading is not always illegal. In certain instances, individuals in possession of insider knowledge can disclose their trading activity to the SEC. However, disclosure alone is not enough to make trading on the basis of insider information legally acceptable. Another instance in which the officers of publicly held companies can legally transact securities involves **pre-arranged trading plans**. For example, SEC Rule 10b5-1 permits executives at public companies to transact securities so long as it is arranged in good faith beforehand to take place on certain predetermined future dates and involves pre-set amounts. So long as these criteria are followed, they are granted safe harbor. **Safe harbor**, in this context, refers to exemption from insider trading charges for compliant pre-arranged equity trades.

## Schedule 13D

In 1968, the Williams Act amended the Securities Exchange Act of 1934 so that investors could have advance warning of possible corporate takeovers. If someone (individual/corporation) becomes the **beneficial owner** of more than 5% of a company's stock, that entity must file a Schedule 13D with the SEC within 10 days of purchase. A beneficial owner is anyone with "voting and investment power over their shares." There are a few exceptions that apply, such as qualified **institutional investors**—large investors who are deemed to have sophisticated knowledge of securities such that they do not need the same level of protection as general investors. Insurance companies, state employee benefits plans, and investment companies are examples of qualified institutional investors who are allowed to report their holdings at the end of the calendar year.

## Insider Transactions

**Corporate insiders** are those officers, directors, and beneficial owners who own more than 10% of a class of securities, registered under Section 12 of the Securities Exchange Act of 1934. Corporate insiders must file a statement of ownership with the SEC to be in compliance, and as of August 27, 2002, the SEC implemented new rules that shortened the time period to report insider transactions. It is important for a company to have internal controls and a system to ensure their corporate insiders are reporting their trades in a timely fashion. Companies that do not implement and enforce compliance procedures can become liable for the actions of their employees who fail to follow the law.

## Reporting Requirements

Publicly owned companies that meet certain size requirements are called **reporting companies**, and per Section 13(a) of the Securities Exchange Act of 1934, they must file periodic disclosures. The purpose of these disclosures is to help investors make educated decisions regarding how to invest their money. These reports include information about a company's line of business, corporate officers and directors, and financial statements.

- **Form 10-K**. Form 10-K, also known as the annual report, contains **audited** financial statements. Audited financial statements have been reviewed by one or more CPAs who are not affiliated with the company and who provide an objective opinion about whether or not the financial statements, such as the balance sheet, income statement, statement of changes to retained earnings, and cash flow statement, conform with accounting standards known as the Generally Accepted Accounting Principles (GAAP). When the Securities Exchange Act of 1934 was first passed, most companies' annual reports contained only the bare minimum amount of information. However, over time, companies came to view their annual reports as a way to not only comply with SEC requirements, but also to attract new investors and impress securities analysts, or financial professionals who study various industries to make recommendations on whether a security should be bought, held, or sold. Today, many annual reports contain not only the required facts, but also compelling narratives that detail the company’s mission and strategic goals. The annual reports of certain companies—for example, Berkshire Hathaway, written by Warren Buffett and Charlie Munger—provide not only their opinions on their own operations, known as the **management discussion**, but also their thoughts on the economy overall. The Form 10-K is a large responsibility for a company because it must disclose the company’s analysis of its financial conditions, potential market risks, internal controls, legal proceedings, defaults, and other information that is deemed important for investors to make sound investment decisions.

- **Form 10-Q**. Form 10-Qs are quarterly **unaudited** financial statements that contain financial information. Since they are unaudited, they are less expensive and time-consuming for the company to prepare; however, investors do not have the additional assurance that they have been analyzed by a neutral CPA.
- **Form 8-K**. Certain events require the company to file a **Form 8-K**, such as a change in the company’s officers, mergers, or declarations of bankruptcy. These are required to be filed within four business days with the SEC.
- **Proxy Statements**. Proxy statements are documents that the SEC requires that shareholders of companies with securities registered under Section 12 of the Securities Exchange Act of 1934 receive to allow them to vote on issues that will be decided at a stockholder meeting. This process is commonly applied when voting for directors or deciding corporate actions. Even shareholders who own just one share of a company receive proxy statements; thus, the process of sending out these statements is a large undertaking for companies. While some companies still use the mail to deliver proxy statements, others send a “Notice of Internet Availability of Proxy Materials” to shareholders a minimum of 40 days before the shareholders’ meeting.

### Ongoing Responsibilities

Businesses must stay current with changes in securities laws that impact their liabilities and responsibilities. The Exchange Act allows the SEC to make new laws, like it did in 2000 with Regulation FD, which stands for “fair disclosure”. In 2013, the SEC started to allow the use of social media channels, in certain circumstances, as a means of distributing information to shareholders.

### Summary

These two sections have provided an overview of some of the most important points of the Securities Exchange Act of 1934. Considering the sheer number of exceptions and complexities, coupled with today’s rapidly changing technological and political climates, a successful company needs competent legal counsel to help it navigate the compliance requirements of the SEC. While certain illegal actions can be due to malicious intent, such as insider trading, this situation is not always the case; a corporate insider can fail to comply simply because he or she is not aware of the nuances of the law.

## 14.2 The Framework of Securities Regulation

### The Securities Exchange Act of 1934

In 1929, the United States stock market crashed and lost $25 billion, which would be approximately $319 billion today. The Stock Market crash of 1929 was one cause of the American Great Depression of the 1930s, which caused the failure of nearly half of American banks and created unemployment rates of almost 25 percent by

1933. These dire economic conditions created the need for **breadlines**, quite literally, hungry people who waited in line at charitable and government organizations for loaves of bread, and **shanty towns**, or areas where families who had lost their homes lived in cloistered tents on the outskirts of cities. Farmers could not even afford to harvest their crops.

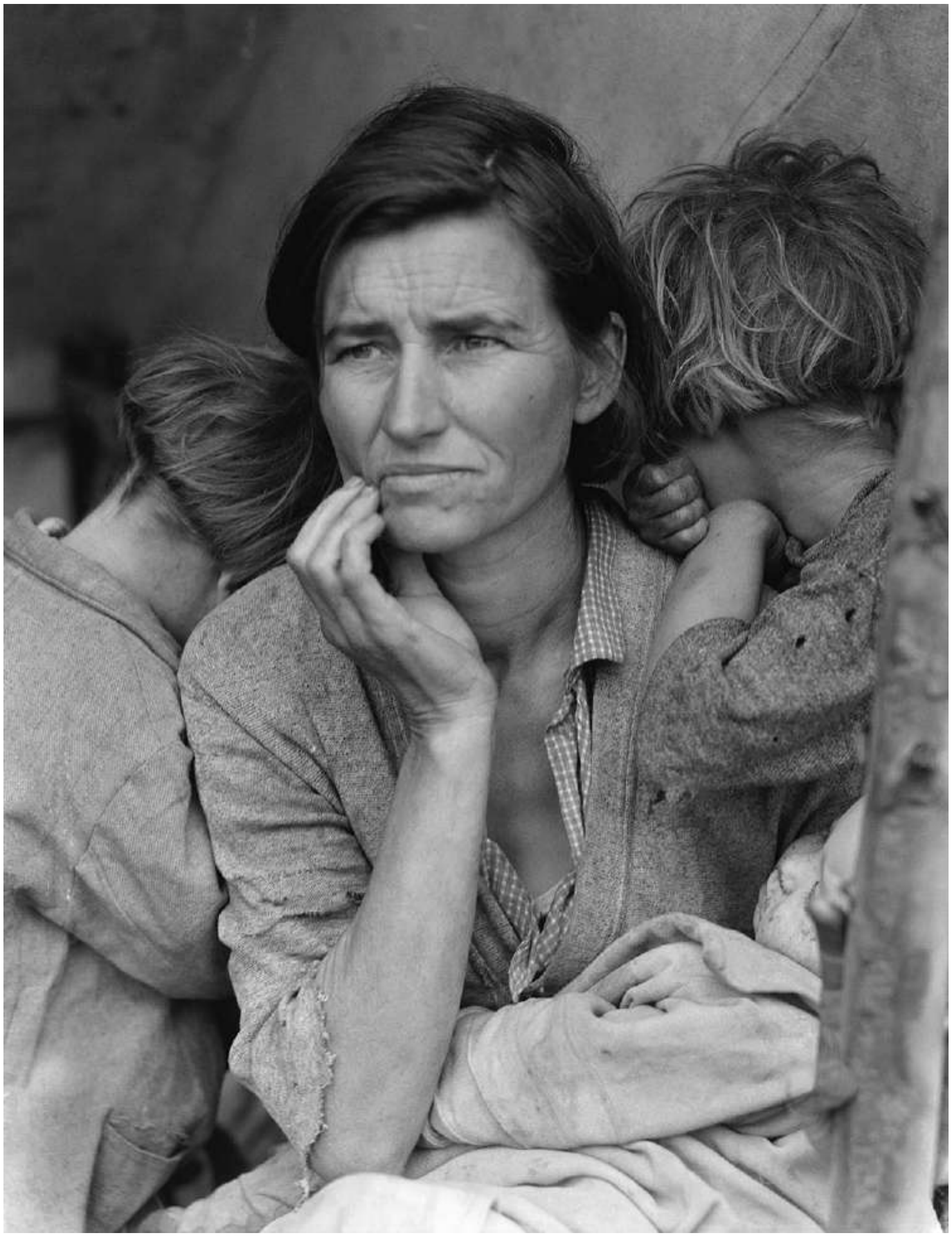

**Figure 14.3** Florence Owens Thompson and her children were living on frozen vegetables and birds they killed in this famous photograph taken in 1936 in California. (Credit: Dorothea Lange/ wikimedia/ License: Public Domain)

It was amid this social and economic unrest that Congress passed the Securities Exchange Act of 1934. Signed by President Franklin D. Roosevelt, the Securities Exchange Act of 1934 recognized that the stock market crash of 1929 was caused by wild speculation, large and sudden fluctuations, and manipulations involving securities. An article in the 1934 **California Law Review** described the condition of the market at the time by writing, “Artificial prices of securities were the rule rather than the exception.... The result was vast economic power, with all that implies in a democracy, in the hand of men whose ethical standards were substantially those of gangsters.”

Roosevelt wanted to enact legislature to try to prevent this wild speculation in securities from happening again and to restore the public’s faith. He recognized that stock market crashes would not only destroy wealth in securities markets, but they were also instrumental to the financial security of the nation as a whole. The passing of the Security Exchange Act of 1934 was not only a reaction to the market crash, but it also represented a broad shift in the social and economic paradigms and legal frameworks of the United States. Previously, the United States had largely followed a **laissez-faire** economic policy. Laissez faire, as popularized by Scottish economist Adam Smith and British philosopher Herbert Spencer, describes an economic philosophy that markets function best when left to their own devices, i.e., without, or with minimal, government involvement or regulations. The rejection of laissez faire was part of a larger social shift that opposed the long hours, unsafe working conditions, and child labor that had become commonplace as a result of the Industrial Revolution.

## The SEC

Section 4 of the Securities Exchange Act of 1934 created the **Securities and Exchange Commission (SEC)** to enforce its ongoing mission. The SEC is an independent agency of the United States federal government. It regulates securities laws and regulations. The first chairperson of the SEC was Joseph P. Kennedy, the father of President John F. Kennedy. The SEC is led by five presidentially appointed commissioners and has five divisions: Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, Division of Enforcement, and Division of Economic and Risk Analysis.

The SEC also oversees **self-regulatory organizations (SROs)**, or private organizations that create and enforce industry standards. These organizations are allowed to “police” themselves, but are subject to compliance with SEC regulations. The various well-known securities exchanges such as the New York Stock Exchange (NYSE), the National Association of Securities Dealers Automated Quotation System (NASDAQ), and the Chicago Board of Options are SROs. Per Section 12(g), companies with total assets exceeding $10 million and with 500 or more owners of any class of securities must register with the SEC unless they meets exemption requirements.

The SEC makes new laws in response to emerging technologies. For example, Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 was added, and in it, Section 4(a)(6) allows **crowdfunding**, or raising small amounts of money from many people to fund a venture or project, usually over the internet. Crowdfunding transactions are exempt from registration as long as the amount raised does not exceed $1,070,000 in a 12-month period.

## Secondary Markets

The Securities Exchange Act of 1934 governs **secondary markets**, or what is typically referred to as the “stock market.” In contrast to the **primary market**, which involves the **initial** sale of a security, such as through an **initial public offering (IPO)**, secondary markets involve subsequent buyers and sellers of securities. One key difference is that primary market prices are set in advance, while secondary market prices are subject to constantly changing market valuations, as determined by supply and demand and investor expectations. For example, when Facebook initiated its IPO in May of 2012, the price was $38 per share, and technical issues on the NASDAQ complicated the offering. After the IPO, the stock traded **sideways**, meaning that it stayed within a range that did not indicate strong upward or downward movement. However, Facebook has gone on to trade at values more than four times its initial IPO valuation, due to investor beliefs and expectations. Not all stocks go up in value after their IPO; some vacillate between highs and lows and frustrate investors with their unstable valuation swings.

**Figure 14.4** Stocks on the secondary market fluctuate in value. (Credit: 3844328/ pixabay/ License: CC0)

## Reporting Requirements

The Securities Exchange Act of 1934 created numerous reporting requirements for public companies. The purpose of these requirements was **transparency**, that is, keeping the public up to date and informed of changes that might impact securities prices. Public companies with securities registered under Section 12 or that are subject to Section 15(d) must file reports with the SEC. Section 12 requires the registration of certain securities and outlines the procedures necessary to do so. Information required by Section 12 includes the nature of the business, its financial structure, the different classes of securities, the names of officers and directors along with their salaries and bonus arrangements, and financial statements. Section 15 requires brokers and dealers to register with the SEC. Individuals who buy and sell securities are considered traders, and therefore, are not subject to filing under Section 15. Section 15(d) requires registered companies to file periodic reports, such as the the annual Form 10-K and the quarterly Form 10-Q. These reports will be explained in detail in the next section of this chapter. The SEC Commission makes these reports available to all investors through the EDGAR website to help them make informed investment decisions.

## Registration Requirements

The Securities Act of 1933 required companies initiating securities offers and exchanges to register with the SEC, unless they met exemption criteria. Section 5 of the Securities Exchange Act of 1934 built upon this foundation and made it unlawful to transact on unregistered exchanges and specifically extended this regulation to the usage of the mail and interstate commerce. 15 U.S. Code § 78f states that exchanges must not only register with the SEC, but they must also have rules that “prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest …"

## Blue Sky Laws

When the Securities Exchange Act is discussed, **blue sky laws** are often mentioned. In 1911, Kansas bank commissioner J.N. Dolley became concerned about what he called "swindles," in which investors at the time lost money by investing in "fake mines" or "a Central American plantation that was nine parts imagination." Therefore, he lobbied for the first "comprehensive" securities law in the United States because, as he phrased it, these investments were backed by nothing except the blue skies of Kansas. So, state-level securities laws aimed to combat fraud are called blue sky laws. The SEC does not have jurisdiction over activities within states and does not enforce blue sky laws.

**Figure 14.5** In addition to the Securities Exchange Act of 1934, blue sky laws provide an additional state-level layer of legal protection for the public. (Credit: Elia Clerici/ pexels/ License: CC0)

## Assessment Questions

**1.** Explain a laissez-faire economic policy.

**2.** The following are examples of self-regulatory organizations that the SEC oversees:

a. The New York Stock Exchange.
b. The National Association of Securities Dealers.
c. The Chicago Board of Options.
d. All of the above.

**3.** Which types of companies must register with the SEC?

a. Companies with over 500 or more owners.
b. Companies with total assets of $10 million.
c. Companies with total assets exceeding $10 million and with 500 or more owners.
d. None of the above.

**4.** Explain Blue Sky laws.

**5.** Distinguish between primary markets and secondary markets.

**6.** Define insider trading.

**7.** All of the following are considered reports required by the Securities Exchange Act of 1934 except:

a. Form 8k.
b. Form 10 k.
c. Form 10Q.
d. All of the above.

**8.** Corporate insiders include officers, directors, and beneficial owners who own _____ % of a class of securities registered under Section 12 of the Securities Exchange Act of 1934.

a. 5.
b. 10.
c. 15.
d. 20.

**9.** Explain Schedule 13D.

**10.** What's the purpose of Proxy Statements?

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# Answer Key

## Chapter 1

**1**. b
**3**. a
**5**. a
**7**. d
**9**. *What is the supreme law of the land?* The federal constitution is the supreme law of the land. *What are statutes?* Laws enacted by Congress or a state legislative body. *What are ordinances?* Laws enacted by local legislative bodies. *What are administrative rules?* Laws issued by administrative agencies under the authority given to them in statutes.
**11**. The term "unfair trade practices" is broadly used and refers to any deceptive or fraudulent business practice or act that causes injury to a consumer. Some examples include, but are not limited to, false representations of a good or service including deceptive pricing, non-compliance with manufacturing standards, and false advertising. The FTC investigates allegations of unfair trade practices raised by consumers and businesses, pre-merger notification filings, congressional inquiries, or reports in the media and may seek voluntary compliance by offending businesses through a consent order, administrative complaints, or federal litigation.
**13**. c
**15**. b

## Chapter 2

**1**. a
**3**. The process by which parties with nonidentical preferences allocate resources through interpersonal activity and joint decision making.
**5**.

The Thomas-Kilmann Conflict Mode Instrument (TKI) is a questionnaire that provides a systematic framework for categorizing five broad negotiation styles. It is closely associated with work done by conflict resolution experts Dean Pruitt and Jeffrey Rubin. These styles are often considered in terms of the level of self-interest, instead of how other negotiators feel. These five general negotiation styles include:

Forcing. If a party has high concern for itself, and low concern for the other party, it may adopt a competitive approach that only takes into account the outcomes it desires. This negotiation style is most prone to zero-sum thinking. For example, a car dealership that tries to give each customer as little as possible for his or her trade-in vehicle would be applying a forcing negotiation approach. While the party using the forcing approach is only considering its own selfinterests, this negotiating style often undermines the party's long-term success. For example, in the car dealership example, if a customer feels she has not received a fair trade-in value after the sale, she may leave negative reviews and will not refer her friends and family to that dealership and will not return to it when the time comes to buy another car. Collaborating.

Collaborating. If a party has high concern and care for both itself and the other party, it will often employ a collaborative negotiation that seeks to maximum the gain for both. In this negotiating style, parties recognize that acting in their mutual interests may create greater value and synergies.

Compromising. A compromising approach to negotiation will take place when parties share some concerns for both themselves and the other party. While it is not always possible to collaborate, parties can often find certain points that are more important to one versus the other, and in that way, find ways to isolate what is most important to each party.

**7**. a
**9**.

E-mediation can be useful in situations where the parties are geographically far apart, or the transaction in dispute took place online. Ebay uses e-mediation to handle the sheer volume of misunderstandings between parties. Research has shown that one of the benefits of e-mediation is that it allows people the time needed to "cool down" when they have to explain their feelings in an email, as opposed to speaking to others in person.

In addition to technological advancements, new findings in psychology are influencing how disputes are resolved, such as the rising interest in canine-assisted mediation (CAM), in which the presence of dogs is posited to have an impact on human emotional health. Since the presence of dogs has a positive impact on many of the neurophysiological stress markers in humans, researchers are beginning to explore the use of therapy animals to assist in dispute resolution.

**11**. c
**13**. In binding arbitration, the decision of the arbitrator is final, and except in rare circumstances, neither party can appeal the decision through the court system. In non-binding arbitration, the arbitrator's award can be thought of as a recommendation: it is only finalized if both parties agree that it is an acceptable solution.
**15**. c

## Chapter 3

**1**. Acceptable levels of behavior for each individual who makes up the organization.
**3**. b
**5**. a
**7**. The earliest published book about the topic is *Corporate Responsibility of the Businessman*, published in 1953. This book introduced the concept of companies giving back as a form of investment in the future. This idea came from a generation that had survived some of the hardest times in our world and wanted to make it a better place for generations to come.
**9**. d

## Chapter 4

**1**.

The authority of the federal government to regulate interstate commerce has, at times, come into conflict with state authority over the same area of regulation. The courts have tried to resolve these conflicts with reference to the police power of the states.

Police power refers to the residual powers granted to each state to safeguard the welfare of their inhabitants. Examples of areas in which states tend to exercise their police power are zoning regulations, building codes, and sanitation standards for eating places. However, there are times when the states' use of police power impacts interstate commerce. If the exercise of the power interferes with, or discriminates against, interstate commerce, then the action is generally deemed to be unconstitutional. The limitation on the authority of states to regulate in areas that impact interstate commerce is known as the dormant commerce clause.

In using the dormant commerce clause to resolve conflicts between state and federal authority, the courts consider the extent to which the state law has a legitimate purpose. If it is determined that the state law has a legitimate purpose, then the court tries to determine whether the impact on interstate commerce is in the interest of the citizens of the state, and will rule accordingly. For instance, an ordinance that banned spray paint, issued in the city of Chicago, was challenged by paint manufacturers under the dormant commerce clause, but was ultimately upheld by the U.S. Court of Appeals because the ban was intended to reduce graffiti and related crimes.

**3**. d
**5**. c
**7**. c
**9**. a

## Chapter 5

**1**. White collar crimes are characterized by deceit, concealment, or violation of trust. They are committed by business professionals. They generally involve fraud, and the employees committing the crimes are motivated by the desire for financial gains or fear of losing business standing, money, or property. Fraud is the

intentional misrepresentation of material facts for monetary gain. This type of crime is not dependent on threats or violence.
**3**. d
**5**. The Foreign Corrupt Practices Act prohibits bribery payments by U.S. companies to foreign government officials with an intent to influence foreign business results. One example of bribery would be a situation in which a pharmaceutical company offers special benefits to individuals who agree to prescribe their medications.
**7**. b
**9**. d

## Chapter 6

**1**. Torts are wrongs committed against others who suffer some form of damage as a result.
**3**. d
**5**. a
**7**. b
**9**. a

## Chapter 7

**1**. A contract is defined as an agreement between two or more parties that is enforceable by law.
**3**. d
**5**. b
**7**. d
**9**. If a person lacks the mental capacity to enter a contract, then either he or she, or his or her legal guardian, may void it, except in cases where the contract involved necessities. In most states, mental capacity is measured against the “cognitive standard” of whether the party understood its meaning and effect.
**11**. A material breach is when something substantially different from what was expected under the terms of the contract is delivered, the breach is considered material.
**13**. Rescission terminates the duties of both parties under the contract, while reformation allows courts to equitably change the contracts substance.
**15**. Restitution restores the injured party to status quo or the position they had prior to the formation of the contract, by returning the plaintiff any money or property give pursuant to the contract.

## Chapter 8

**1**. A sales contract is s specific type of contract is which one party is obligated to deliver to deliver and transfer ownership of a good to a second party, who in turn is obligated to pay for the good in money, or its equivalent.
**3**. b
**5**. A shipment contract occurs when it is the responsibility of the seller to make the shipping arrangements and to transfer the goods to the common carrier. Under this contract, title passes to the buyer at the time of shipment, so the buyer bears the risk of loss, even when he or she has not taken possession of the goods. A destination contract occurs when the seller is required to deliver the goods to a location that is stipulated in the contract. Under this contract, title transfers when the goods are delivered, but the seller bears the risk of loss until that time.
**7**. An express warranty is one in which the seller explicitly guarantees the quality of the good or service sold. Typically, the vendor provides a statement, or other binding document, as part of the sales contract. In certain circumstances where no express warranty was made, the law implies a warranty. This statement means that the warranty automatically arises from the fact that a sale was made.
**9**. d

## Chapter 9

**1**. Compared to other countries in the West, stringent and extensive employee protections came fairly late to the United States. Up until 1959, for example, employers had the right to fire a worker without giving any reason. This concept, which was known as at-will employment, was applicable in all states. The concept of at-will employment does, however, continue today, and all employees are considered to be at-will unless they are employed under a collective bargaining agreement, or under a contract for a set duration. Employers can still fire employees for any reason, but they cannot be fired for illegal reasons, as set out in the U.S. or state constitutions, federal law, state statutes, or public policy. In this section, some of the main employee rights and company responsibilities will be introduced.
**3**. a
**5**. d

**7**. A trade union, or labor union, is an organized group of workers who come together to lobby employers about conditions affecting their work.
**9**. b
**11**. The Civil Rights Act provides broad provisions pertaining to citizens' civil rights. Title VII of the Civil Rights Act deals with discrimination in employment. It bans employers from discriminating against employees in their hiring, firing, and promotion practices on the basis of sex, national origin, color, religion, or race. All employers who are engaged in commercial activity and who employ 15 or more employees for 20 consecutive weeks in a year are covered by the Act.
**13**. c
**15**. a

## Chapter 10

**1**. Administrative law is also referred to as regulatory and public law. It is the law that is related to administrative agencies. Administrative agencies are established by statutes and governed by rules, regulations and orders, court decisions, judicial orders, and decisions.
**3**. c
**5**. The FDA was created to protect the public's health. The agency's responsibilities are very broad. The agency fulfills its role by ensuring the safety and effectiveness of drugs consumed by people and animals, biological products, medical devices, food, and cosmetics.
**7**. d
**9**. c

## Chapter 11

**1**. b
**3**. Naked restraint occurs as contracts promote a general restraint of competition. If the restraint was created with a goal of long-term impact without boundaries, it was considered to be a naked restraint. Ancillary restraint occurs as the restriction is limited in time and geography. With ancillary restraint, the restraint would be short-term and limited in scope. The courts tended to frown upon naked restraint, but were less consistent with ancillary restraint.
**5**. The original purpose of antitrust legislation, i.e., to foster competition that results in lower prices, more products, and more equal distribution of wealth between producers, remains relevant today.
**7**. b
**9**. c
**11**. c
**13**. a
**15**. The FTC did not formally have a consumer protection mission until the passage of the Wheeler-Lea Act in 1938. This act gave the FTC the power to combat false advertising for any foods, drugs, medical devices, or cosmetics. In addition to the Wheeler-Lea Act, subsequent amendments to the FTC Act, as well as judicial respect toward the agency, broadened the power and jurisdiction of the FTC.

## Chapter 12

**1**. The term "unfair trade practice" describes the use of deceptive, fraudulent, or unethical methods to gain business advantage or to cause injury to a consumer. Unfair trade practices are considered unlawful under the Consumer Protection Act. The purpose of the law is to ensure that consumers have the opportunity to make informed, rational decisions about the goods and services they purchase.
**3**. Bait and switch is a form of false advertising whereby the company advertises a product or service and then sells another item in its place.
**5**. c

## Chapter 13

**1**. International law relates to the policies and procedures that govern relationships among nations.
**3**. The European Union (EU) is a regional international organization that includes many countries in Europe. It was established to create peace across the region and promote economic, social, and cultural development.
**5**. a
**7**. The Principle of Comity states that nations will defer to the laws and decrees of other nations when those laws are consistent with their own, essentially upholding reciprocity between nations with similar laws.
**9**. b

# Chapter 14

**1**. Laissez faire, as popularized by Scottish economist Adam Smith and British philosopher Herbert Spencer, describes an economic philosophy that markets function best when left to their own devices, i.e., without, or with minimal, government involvement or regulations.

**3**. c

**5**. The Securities Exchange Act of 1934 governs secondary markets, or what is typically referred to as the “stock market.” In contrast to the primary market, which involves the initial sale of a security, such as through an *initial* public offering (IPO), secondary markets involve subsequent buyers and sellers of securities. One key difference is that primary market prices are set in advance, while secondary market prices are subject to constantly changing market valuations, as determined by supply and demand and investor expectations.

**7**. d

**9**. In 1968, the Williams Act amended the Securities Exchange Act of 1934 so that investors could have advance warning of possible corporate takeovers. If someone (individual/corporation) becomes the beneficial owner of more than 5% of a company’s stock, that entity must file a Schedule 13D with the SEC within 10 days of purchase. A beneficial owner is anyone with “voting and investment power over their shares.” There are a few exceptions that apply, such as qualified institutional investors—large investors who are deemed to have sophisticated knowledge of securities such that they do not need the same level of protection as general investors. Insurance companies, state employee benefits plans, and investment companies are examples of qualified institutional investors who are allowed to report their holdings at the end of the calendar year.

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