

eleventh
edition

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PRINCIPLES of BUSINESS LAW

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Preface

As we enter the decade of the 1980's, most business law courses are concerned with the legal environment in which business is conducted. This legal environment includes not only the legal principles of such important subjects as contracts but also encompasses such topics as the court system and consumerism. This eleventh edition continues our effort to environmentalize business law.

This edition is divided into eight "books." Each book, except the first and last, contain cases. Book I discusses the various sources of law and our legal system. It traces a lawsuit from the pleadings through the appellate process. It also contains a detailed discussion of arbitration as an alternative to litigation.

Because of the growing impact of the criminal law on contemporary society and the business community, Book I contains a special chapter on that subject. Another example of the environmentalization of the material is found in the discussion of the law of torts, including the trend toward no-fault in auto accident litigation. The chapter on torts contains a discussion of the liability of accountants because of the importance of this subject, especially for C.P.A. candidates.

As in the past, Books II through VII have cases at the end of each chapter. There are 232 such cases or an average of six per chapter. Of the 232 cases, 121 are new to this edition. Many of these new cases were decided in 1976 and 1977. As the courts in recent years have tended toward more "social engineering" and have developed new theories and new approaches to old problems, we believe that it is very important for the students to study the

most recent cases. Moreover, we believe that students "relate" more to modern cases than to old cases however sound and well-written they may be.

The eleventh edition expands its coverage of consumer and debtor protection. In addition to the new Federal Trade Commission rule on holders in due course, Chapter 27 contains material on the Magnuson-Moss Warranty Act and the FTC rule on home solicitation sales. The 1977 statute on fair debt collection practices is also discussed.

Throughout the text, we have attempted to illustrate to the student that the law is in a constant state of change and that the dynamic quality of the law is its ability to adapt to changing conditions. Such a trend as the granting of greater protection to debtors in mortgage foreclosures by prohibiting deficiency judgments is illustrative of this attempt. The trend toward greater government regulation of business decisions is highlighted in Chapter 40. This chapter encompasses the application of the Sherman Act to the service sector in its discussion of price-fixing by lawyers. It also covers such subjects as sex discrimination and OSHA.

This edition continues the format of the preceding edition. The Uniform Commercial Code is included as supplementary material. The appropriate sections of the Code are referenced in the body of the text by use of section numbers. We have also included the Revised Article 9 of the Code which has now been adopted by some states and which the others are considering for adoption.

New to this edition is the inclusion in the appendix of the Uniform Partnership Act, the Uniform Limited Partnership Act, the Revised Uniform Limited Partnership Act, and the Model Business Corporation Act. These Acts are not footnoted in the text but are available for those students and professors who wish to use them.

In the preparation of this manuscript, we continue to recognize the difference in the educational needs of lawyers and of business persons. We have attempted to meet the needs of business persons in the years ahead by stressing those aspects of law that are essential to the decision-making process. We believe the material will make a valuable contribution to the education of tomorrow's business leaders, who must be familiar with the legal aspects of business problems. However, we have deleted most of the procedural issues from the cases and have deleted case references and footnotes as well. Since we believe that students should be required to study the language and reasoning of the courts on substantive issues, we have attempted to include those portions of the cases which show the arguments of each party and the court's resolution of the issues raised. We have attempted to avoid long cases, but at the same time, we believe that case study makes a substantial contribution to the student's education and that the cases should be long enough to provide a good vehicle for class discussion.

As supplementary aids, there are review questions and problems at the end of each chapter. Approximately one-half of these are new for this eleventh

edition. They were prepared by Professor Jan Henkel of the University of Georgia, and we are grateful to him for them. In addition, Professor Barbara George has prepared a student workbook to accompany the text, and we are grateful to her for it.

We also wish to express our deep appreciation to Professor Frank S. Forbes, Chairman, Department of Law and Society, University of Nebraska, Omaha, for his detailed and perceptive reviews.

Finally, we wish to thank Donna Weber for preparation of the manuscript.

Robert N. Corley
William J. Robert



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book one

*LAW,
ITS
SOURCES
AND
PROCEDURES*

Law and Its Sources

1. Introduction

The subject matter of this text is business law. Before starting the study of business law, one should have an understanding of our legal system—where our laws come from, how they are applied, how they may be changed, and the role of law in our society. Also, if the business-related portion of the subject is to be understood, it is essential that certain terms be defined and classifications be established in advance. Thus, the first six chapters of this text will be devoted to a study of sources of law, the legal system and its procedures. In addition, there will be chapters on criminal law and torts that have a direct impact on the business community.

Now more than ever before in our nation's history, the direct relationship between law and the problems facing our society has a direct and substantial impact upon business and its decision-making processes. Solutions to many of society's problems are found in laws regulating business activity. For example, the basic approach to solving the problems of air and water pollution is found in the law. In the area of employment, legislation now affects the hiring of employees as well as their pay and promotion, especially with regard to minority groups and women. In the field of consumer protection, new laws have been enacted regulating the debtor-creditor relationship and other matters of consumer interest. Many of the laws regulating business activity are included with the materials throughout the text.

2. Definitions of Law

In everyday conversation, people use the word *law* in many different ways. Actually, the word *law* is very difficult to define. In its broad context it expresses a variety of concepts. Law has been defined as those rules and regulations established by government and applied to people in order for civilization to exist. Law and legal theory, however, are far too complex for such a simple definition to suffice; thus, other definitions must be examined if the connotations of the word *law* are to be effectively understood.

In attempting to define *law*, it is helpful to look at its purposes or functions. It is fundamental that a basic purpose of law in a civilized society is to maintain order. This is the prime function of that body of law known as the *criminal law*. Another role of law is to resolve disputes that arise between individuals and to impose responsibility if one person has a valid legal claim against another. Suits for breach of contract would be an example of the latter. It is important to bear in mind that the law is not simply a statement of rules of conduct but is also the means whereby remedies are afforded when one person has wronged another.

Many legal scholars have defined law in relation to the sovereign. For example, Blackstone, the great legal scholar of the eighteenth century, defined law as "that rule of action which is prescribed by some superior and which the inferior is bound to obey." This concept of law as a command from a superior to an inferior is operative in many areas. For example, the tax laws command that taxes shall be paid to the sovereign.

Law has also been defined as the product of the legal system. For example, Justice Oliver Wendell Holmes in one case said, "Law is a statement of the circumstances in which the public force will be brought to bear through courts." In this definition, Holmes used the word *law* in its broad sense and took cognizance of the fact that in our society, all issues and disputes—political, social, religious, economic, or otherwise—ultimately become legal issues to be resolved by courts. Law, according to this definition, is simply what the courts determine it to be as an expression of the public will.

Law has also been defined as a scheme of social control. This definition acknowledges the role of law in governing and regulating a civilized society. Implied in this definition is the dynamic role of law as an instrument of social, political, and economic change. The law is both an instrument of change and a result of change. It is often difficult to determine whether the law brings about changes in society or whether changes in society bring about a change in the law. In our legal system, both are often true. The law—responding to the goals, desires, needs, and aspirations of society—is in a constant state of change. In some areas, it changes more rapidly than does the attitude of a majority of society. In these areas, the law and our legal system provide leadership in bringing about desirable changes. In some areas, most of society is ahead of the law in moving in new directions; other institutions then assume

leadership, with the law cast in the role of follower. In either case, the legal system is an integral part of any change in society.

The definition of law as a scheme of social control recognizes that law exists for the protection of social interests, both those between government and individual and those between individuals. In a sense, law as a means of social control influences people in their actions because the control sought may be obtained by state action if necessary.

Law has also been defined as the body of principles, standards, and rules that the courts apply in the decision of controversies brought before them. By this definition, law consists of three elements: (1) formulated legislation, including constitutions, statutes, and treaties; (2) case law, or the common law created by judicial decision; and (3) procedural rules, which determine how lawsuits are handled in the courts and include such matters as the rules of evidence and related issues. The first two elements provide the rules of substantive law that are applied by the courts to decide controversies. The third provides the machinery whereby these rules of substantive law are given effect and applied to resolve controversies.

3. Forces That Shape the Law

Throughout history, legal scholars have written about the nature and origin of law, its purposes, and the factors that influence its development. Legal philosophers have generally acknowledged that logic, history, custom, religion, and social utility are among the major influences and forces that have shaped and directed the law. But there has been disagreement as to the relative importance of these forces, and the influence of each has varied throughout history.

Logic. Judicial reasoning often involves the use of prior decisions as precedents. The use of the analogy is of prime importance to the judicial process because of the need for certainty in the law. Logic may involve deductive reasoning or inductive reasoning. Deductive reasoning takes the form of a syllogism in which a conclusion concerning a particular circumstance (minor premise) is drawn from a general principle (major premise). Inductive reasoning involves the process of using specific cases to reach a general conclusion. It is often said that application of the doctrine of *stare decisis* by basing a decision on precedents announced in prior cases is inductive in nature, while applying a statute to a given set of facts is an example of deductive reasoning, but these examples are open to some criticism. In addition, the development of the law using logic would require that the law consist of a set of known rules. Since it does not, pure logic cannot always be used to decide cases. However, reasoning by example is at the heart of our judicial system.

In any case, "The life of the law has not been logic; it has been experience" (Justice O.W. Holmes). In this statement and in his definition of law as a prediction of what courts will decide, Justice Holmes stressed the empirical and

pragmatic aspects of the law with primary reliance on facts to dictate what the law is. Yet he recognized that law is actually unpredictable and uncertain.

History and Custom. History and custom play a significant role in the development of the law in many areas. The law tends to evolve as we learn from history. As customs and practices gain popular acceptance and approval, they become formalized into rules of conduct. Law was found in the rules and evolved from them. Custom results from repeated approved usage, and when such usage by common adoption and acquiescence justifies each member of society in assuming that every other member of society will conform thereto, a rule of conduct has been formulated. When such a rule is adopted by a court as controlling in a particular case or is enacted into legislation, law has been made.

Religion. Throughout history, religious principles have played a major role in the development of the law. Many legal theorists have argued that there exists a natural law, based on divine principles established by the Creator, which mortal man is bound to follow.

This natural-law theory softened the rigid common law of England, became the basis of courts of equity, and, finding its way to America, is expressed in the Declaration of Independence in the words "certain unalienable Rights, . . . Life, Liberty, and the Pursuit of Happiness."

Social Utility. Law was previously defined as a scheme of social control. Social utility is perhaps the most significant force influencing the development of the law today. Social utility involves the use of economic, political, and social considerations as factors in formulating the law. Under the pressure of conflicting interests, legislators and courts make law. Thus, law, when enacted by legislatures or pronounced by courts, is in the end the result of finding an equilibrium between conflicting interests.

Law is not only generalization deduced from a set of facts, a recognized tradition, a prescribed formula for determining natural justice, but it also consists of rules for social control growing out of the experiences of mankind. Current social mores, political ideologies, international situations and conditions, and economic and business interests are all elements to be investigated and evaluated in making the law and in determining how it operates.

4. Classifications of Law

It is not possible to classify accurately the various legal subjects, because so many are overlapping and interrelated. However, one common classification distinguishes substantive law from procedural law. The rules of law that are used to actually decide disputes may be classified as *substantive* law. On the other hand, the legal procedures that provide how a lawsuit is begun, how the trial is conducted, how appeals are taken, and how a judgment is enforced are called *procedural* law. Substantive law is the part of the law that defines rights,

and procedural law establishes the procedures whereby rights are enforced and protected. For example, A and B have entered into an agreement, and A claims that B has breached the agreement. The rules that provide for bringing B into court and for the conduct of the trial are rather mechanical, and they constitute procedural law. Whether the agreement was enforceable and whether A is entitled to damages are matters of substance and would be determined on the basis of the substantive law of contracts.

Law is also frequently classified into areas of *public* and *private* law. Public law includes those bodies of law that affect the public generally; private law includes the areas of the law that are concerned with the relationship between individuals.

Public law may be divided into three general categories: (1) *constitutional law*, which concerns itself with the rights, powers, and duties of federal and state governments under the U.S. Constitution and the constitutions of the various states; (2) *administrative law*, which is concerned with the multitude of administrative agencies, such as the Interstate Commerce Commission, the Federal Trade Commission, and the National Labor Relations Board; and (3) *criminal law*, which consists of statutes that forbid certain conduct as being detrimental to the welfare of the state or the people generally and provides punishment for their violation. These public-law subjects will be discussed later in this and subsequent chapters.

Private law is that body of law pertaining to the relationships between individuals in an organized society. Private law encompasses the subjects of contracts, torts, and property. Each of these subjects includes several bodies of law. For example, the law of contracts may be subdivided into the subjects of sales, commercial paper, agency, and business organizations. The major portion of this text covers these subjects, which constitute the body of law usually referred to as business law.

The law of torts is the primary source of litigation in this country and is also a part of the total body of law in such areas as agency and sales. It is concerned with wrongful acts against a person or his property and is predicated upon the premise that in a civilized society, people who injure other persons or their property must compensate them for their loss.

The law of property may be thought of as a branch of the law of contracts, but in many ways our concept of private property contains much more than the contract characteristics. Property is the basic ingredient in our economic system, and the subject matter may be subdivided into several areas, such as wills, trusts, estates in land, personal property, bailments, and many more.

Any attempt at classification of subject matter, particularly in the private law, is difficult, because the law is indeed a "seamless web." For example, assume that an agent or a servant acting on behalf of his employer commits a tort. The law of agency, although a subdivision of the law of contracts, must of necessity contain a body of law to resolve the issues of tort liability of the employer and employee. Likewise, assume that a person is injured by a product he