

The Legal Environment of Business

Northern Illinois University Special Edition

9th Edition

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The Legal Environment of Business

Northern Illinois University Special Edition

9th Edition

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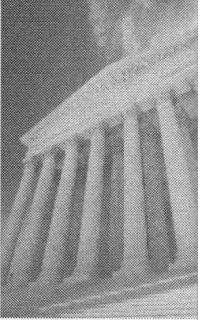
The Legal Environment of Business

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The Modern Environment of Business



Getting full-time employment after college and beginning to build a career are often nerve-wracking. Afraid of being left jobless, some people take less-than-ideal jobs, which sometimes turn out better than expected. On the other hand, some people take what seem to be great jobs, but soon discover otherwise.

It is not uncommon for recruiters to overstate the qualities of a position. A job billed as “character-building” may be one of unending stress. One advertised as having a “team working environment” can mean people jammed in small cubicles. One person reports that while being recruited he was shown a nice office and introduced to his supervisor, whom he liked very much. But when he arrived for work, he was stuck in a back room, the likeable supervisor was gone and replaced by someone he could not stand, and the assignments given were not of the quality discussed.

Suppose that happens to you. Can you sue the recruiter who hired you? Can you sue the company that hired you? Do you have the right to demand a better office? What is your legal status in the situation? These are some of the issues we will explore.

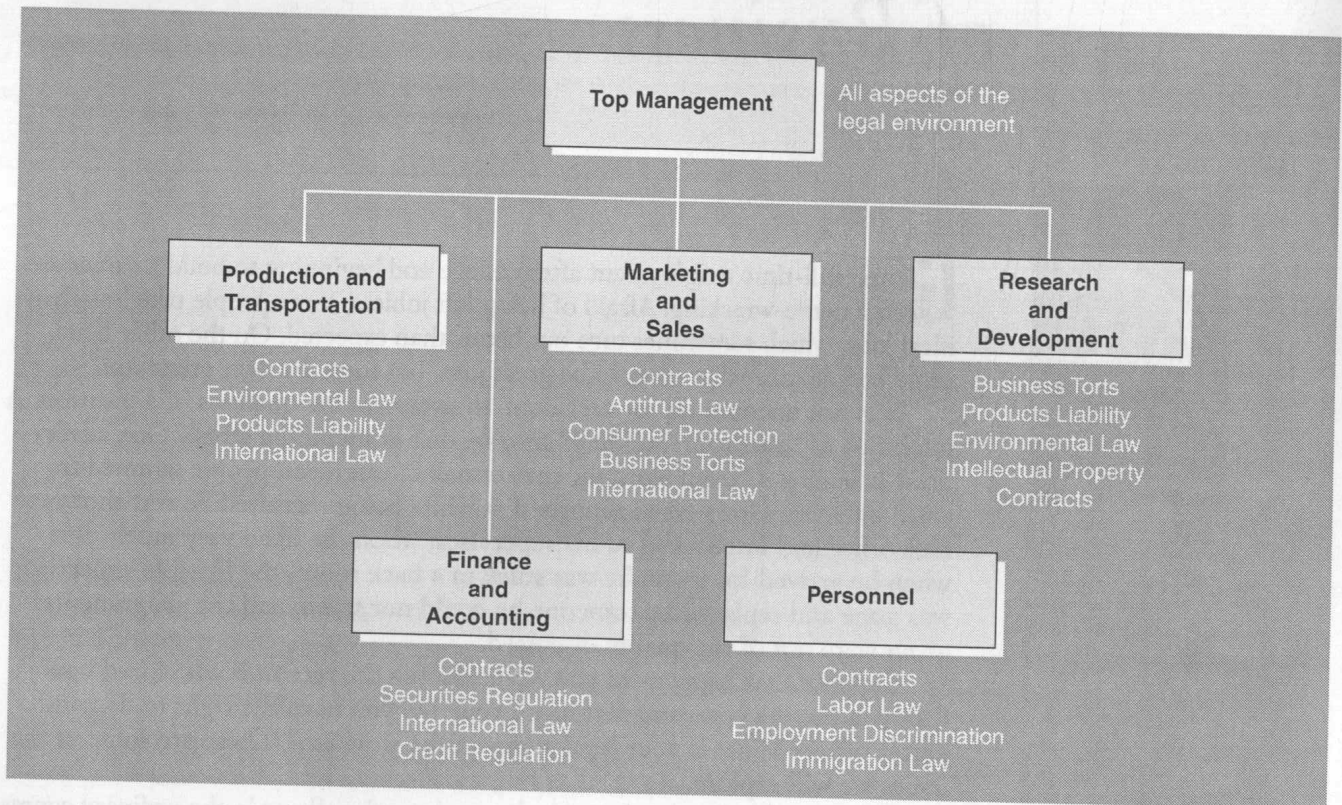
Whether the situation just posed arose intentionally or in the ordinary course of business, the employee probably has little recourse but to keep the job as is, or leave. The employer is unlikely to have violated any legal obligation. But what about the ethical obligation to be honest with current and potential employees? Is overstating the quality of a position unethical, even if it is not in violation of the law? This is another aspect of the modern environment of business.

Because the environment of business is so complex, ethical, legal, social, political, and international issues all impact company operations. As Exhibit 1.1 indicates, whether your field is human resources, banking, advertising, or software development, you must be familiar with a wide range of subjects to have the skills needed to be aware of possible problems and to recognize potential opportunities that someone with a limited view of the world would be likely to miss. This book, which focuses on the legal environment of business, helps to fit one large piece into the complicated puzzle of the modern business world.

The study of the legal environment of business begins with an overview of the nature of law and the legal system. Composed of law from several sources, the legal environment is influenced by the needs and demands of the business community, consumers, and government. This chapter provides an understanding of the functions of law in society, the sources of U.S. law, and the classifications of law. It then considers some major ethical issues that play a large role in the modern environment of business.

Exhibit 1.1

Overview of a Business's Legal Environment



LAW AND THE KEY FUNCTIONS OF THE LEGAL SYSTEM

In the legal environment of business, law refers to a code of conduct that defines the behavioral boundaries for business activity. There is no precise definition of law. Law is an abstract term but has long meant the same general thing. According to *Justinian's Institutes*, a summary of Roman law published in 533 in Constantinople, "The commandments of the law are these: live honorably; harm nobody; give everyone his due." A century ago Oliver Wendell Holmes, a legal scholar and Supreme Court justice, offered the following definition:

Law is a statement of the circumstances, in which the public force is brought to bear . . . through the courts.

In his 1934 book *Growth of Law*, the jurist Benjamin N. Cardozo defined law as follows:

A principle or rule of conduct so established as to justify a prediction with reasonable certainty that it will be enforced by the courts if its authority is challenged.

Consider these modern definitions from *Black's Law Dictionary*, an authoritative legal dictionary:

1. Law, in its generic sense, is a body of rules of action or conduct prescribed by controlling authority, and having binding legal force.
2. That which must be obeyed and followed by [members of a society] subject to sanctions or legal consequences is a law.

Thus, law may be viewed as a collection of rules or principles intended to limit and direct human behavior. By enforcement, such rules or principles provide a measure of predictability and uniformity to the boundaries of acceptable conduct within a society. Nations have both *formal rules*, that is, what are commonly called laws, and *informal or implicit rules* that come from a society's history, customs, commercial practices, and ethics.

Law and the legal system serve several key roles in society. The most important functions include: (1) influencing the behavior of the members of a society, (2) resolving disputes within the society, (3) maintaining important social values, and (4) providing a method for social change. The *International Perspective* feature discusses the efforts in the nation of Chad to develop a legal system that is meaningful to its citizens and attractive to business development. Its experience, which is not unique, reminds us how difficult it is to do business in a country without a workable legal system.

Enhancing Social Stability by Influencing Behavior

The legal system is a major social institution that helps define acceptable behavior and control unacceptable behavior. The law thus limits activities that are detrimental to the "public interest" and encourages beneficial activities. The law restricts business practices that are viewed as outside the ethical and social norms of a society. At the same time, the law can encourage practices that further social and political goals.

The laws in different countries reflect social norms. The business of raising and selling marijuana in Amsterdam (Holland) is legal because the government decided that legalizing marijuana would eliminate the criminal element in the drug trade and make it less likely that people would use harsher drugs that are still illegal, such as cocaine. In the United States, selling marijuana is illegal and can be punished by long prison terms, but the production and sale of alcoholic beverages is legal in most of the country. In Saudi Arabia, people have been executed for being involved in the alcohol business.

Conflict Resolution

The next important function of the law is the resolution of disputes. Disagreements are inevitable, since societies are made up of people with differing desires and social preferences. Karl N. Llewellyn, a legal theorist, states:

What, then, is this law business about? It is about the fact that our society is honey-combed with disputes. Disputes actual and potential, disputes to be settled and disputes to be prevented; both appealing to law, both making up the business of law. . . . This doing of something about disputes, this doing of it reasonably, is the business of law.

One formal mechanism for the resolution of disputes is the court system, which is used for resolving private disputes between members of society and public disputes between a person and the government. Our court system is intended to provide a

INTERNATIONAL



Perspective

Chad: A Third-World Country Tries to Create a Legal System

Chad is in north-central Africa. It is three times the size of California, has a population of eight million people, and has per capita income of about \$200 per year.

Chad must develop a legal system more attractive to the world business community and outside investors. No commonly accepted rule of law exists. Chad's citizens do not like to use the court system, because judges often receive orders from the governing authority on how to decide cases. Disputes are often resolved by an unauthorized system of "courts" established by the police and military authorities. Formal law is often in conflict with the customs of various ethnic groups and so is largely ignored. The lack of a predictable legal system is a significant deterrent to the development of the country's commercial base.

To help resolve these difficulties in the legal system, Professor Louis Alcoin recommended the following:

Reform the court system to improve dispute resolution, with emphasis on ensuring that judges are independent of the governing authority.

Establish a separate court to be used only to resolve commercial disputes.

Write and publish the civil and commercial codes.

Reform the areas of enforcing judgments, business registrations, the investment code, property law, government contracts, and banking.

Publish new legislative acts with the understanding that none would take effect until they are published.

In undertaking these legal reforms, include laws that reflect the country's customs and traditions to the extent appropriate.

In the absence of reforms, the country will not overcome the barriers to development that result from the lack of a reliable or respected legal system.

consistent mechanism for resolving disputes. As we will see in Chapter 3, businesses are increasingly turning to conflict resolution processes outside of the courts.

Social Maintenance

A society is shaped by its values and customs. It is not surprising, then, that law plays a crucial role in maintaining the social environment. Honesty and integrity are reflected by the enforceability of contracts; respect for other people and their property is reflected in tort and property law; and some measures of acceptable behavior are reflected in criminal laws. Consider the issue of gay relationships. Until recent years, gay partners could be subject to criminal prosecution for their actions. Now the discussion has turned to whether such relationships can have the same status as traditional marriages. Some contend that legalizing same-sex marriages would be destructive to the structure of society; others argue that it would be stabilizing.

Social Change

The legal system provides a way to bring about changes in "acceptable" behavior. Behavior that was acceptable at one time may not serve society well today, or in the future, as circumstances change. For example, to help alter behavior, laws restrict race discrimination in decisions to hire, promote, or discharge a worker. In the past, race discrimination was an accepted norm of business behavior. Such behavior is no longer acceptable. Social attitudes have changed.

SOURCES OF LAW IN THE UNITED STATES

The most fundamental source of law is the U.S. Constitution, through which other laws are created. The Constitution creates the branches of government—each of which has the ability to make law. Congress—the legislative branch of government—uses its constitutionally granted powers to create what is often referred to as the fourth branch of government, that is, administrative agencies. Similarly, state constitutions determine the structure of government within a state and establish legal procedures and create various rights and restrictions.

Constitutions

A *constitution* is the fundamental law of a nation. It establishes and limits the powers of government. The U.S. Constitution (Appendix C) allocates the powers of government between the states and the federal government. Powers not granted to the federal government are retained by states or are left to the people.

The U.S. Constitution

The U.S. Constitution is the oldest written constitution in force in the world. It sets forth the general organization, powers, and limits of the federal government. Specifically, the Constitution creates the legislative, executive, and judicial branches of the U.S. government.

This division in governmental power is referred to as the *separation of powers*. It arose out of a fear by the founders of this country that too much power might become concentrated in one governmental branch. The separation of powers means that each branch of government has functions to perform that can be checked by the other branches. The government structure that has developed is illustrated in Exhibit 1.2.

The U.S. Constitution is law that is supreme over state or federal laws that go beyond what the Constitution permits. According to Article VI:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

State Constitutions

The powers and structures of all state governments are based on written constitutions. Like the federal government, the state governments are divided into legislative, judicial, and executive branches. The constitutions specify how state officials are chosen and removed, how laws are passed, how the court systems run, and how finances and revenues are paid and collected. Each state constitution is the highest form of law in a state. Some state constitutions, unlike the U.S. Constitution, are very long and are filled with details because amending state constitutions is often much easier than changing the U.S. Constitution.

Legislatures and Statutes

Congress and the state legislatures are the sources of *statutory law*. Statutes or legislation include much of the law that significantly affects business behavior, such as regulations. For example, in 1972, Congress enacted the Clean Water Act. It sets certain standards for water quality for the nation and granted the Environmental Protection Agency the authority to adopt regulations that would make the goals of the statute effective. Similarly at the state level, every state legislature has passed statutes to regulate the insurance industry, usually accomplished with the help of a state insurance commission. Federal courts may review statutes passed by Congress to ensure that they do not violate the U.S. Constitution. The courts in each state may review statutes passed by their legislature to ensure that they do not violate the constitution of the state or of the United States. If a state legislature passes a statute that violates the U.S. Constitution, and a state court does not strike down the statute, the statute may be stricken by a federal court.

United States Congress

Article I, Section 1, of the U.S. Constitution provides that all power to make laws for the federal government is given to Congress, a legislature consisting of a Senate and a House of Representatives. Of the 20,000 pieces of legislation proposed in each session of Congress, fewer than 200 usually reach the House and Senate floors for debate. Many bills are introduced only for political consumption. Of the bills that receive serious consideration, most die in some committee before they reach the full House or Senate for consideration.

State Legislatures

Each state has lawmaking bodies similar to Congress in their functions and procedures. With the exception of Nebraska, all states have a two-part legislature containing a House of Representatives (sometimes called a House of Delegates or an Assembly) and a Senate. The lawmaking process in state legislatures is similar to the procedure followed by the Congress. Note, however, that in some states voters may directly propose or enact legislation through the voting process in referendums or initiatives.

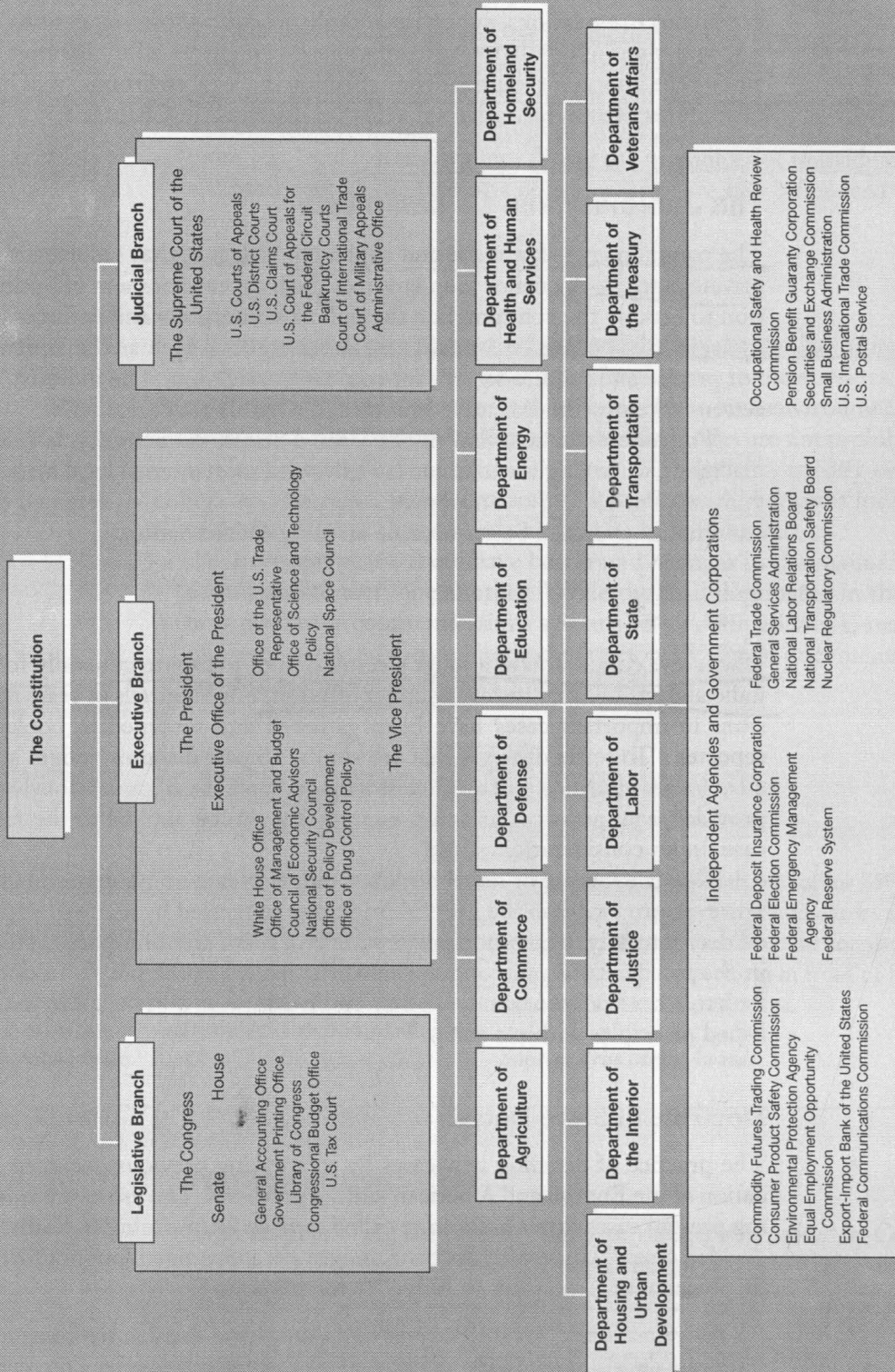
The National Conference of Commissioners on Uniform State Laws works with law professors, the business community, and several legal organizations. For over a century, this organization has proposed "model" laws for consideration by state legislatures. Some are ignored, but others have been widely adopted. An important state law affecting business is the Uniform Commercial Code (UCC). The UCC, discussed in Chapters 11 and 12, is designed to ease the legal relationship between parties involved in commercial transactions by making commercial laws uniform among the various states (and U.S. territories). Another "model" law adopted by most state legislatures is the Uniform Partnership Act, covered in Chapter 13.

Administrative Agencies and Regulations

An administrative agency is created when the legislative or executive branch of the government delegates some of its authority to an agency. Congress (or the state legislature) enacts a law that specifies the duties of the agency. For example, Congress

Exhibit 1.2

The Government of the United States



Note: This chart shows only the more important federal agencies that affect business agencies of the government.

created the Environmental Protection Agency to enact regulations to flesh out the goals of environmental statutes and to be the primary enforcer of those laws. Similarly, all states have created state environmental agencies to help create and enforce state environmental regulation.

With congressional delegation, administrative agencies can exercise broad powers to enact regulations, supervise compliance with those regulations, and adjudicate violations of regulations. Regulations flowing from administrative agencies are among the important sources of law affecting the legal environment of business. The procedures of administrative agencies are discussed in Chapter 5.

The Judiciary and Common Law

The common law—law made and applied by judges as they resolve disputes among private parties—is a major foundation of the legal environment of business. In addition to making the common law, the judiciary interprets and enforces laws enacted by legislative bodies. As we will see, some statutes, such as the antitrust laws, are not precise and require significant court interpretation. The judiciary also reviews actions taken by the executive branch and administrative agencies.

The oldest source of law in the United States, the common law dates to colonial times, when English common law governed most internal legal matters. To maintain social order and to encourage commerce, the colonists retained the common law when the United States became an independent nation.

Case Law

Under the common law, a judge's resolution of a dispute generally follows earlier judicial decisions that resolved similar disputes. For hundreds of years now, the decisions in important cases have been gathered and recorded in books called case reporters. To settle disputes that are similar to past disputes, judges study recorded cases for guidance for their decisions (see Appendix B). A previously decided case provides legal principle, called *precedent*, that can be applied to the facts of a new case under consideration.

To settle unique or novel disputes, judges create new common law. New laws, however, are based on the general principles suggested by many previously recorded decisions. Since common law is state law, there are differences across the states in the interpretation of common-law principles, but the judges in one state often look to cases from other states to help resolve disputes that do not have clearly established principles within a state.

Doctrine of Stare Decisis

The practice of deciding new cases by referencing previous decisions is the foundation of the English and American judicial processes. The use of precedent in deciding present cases forms a doctrine called *stare decisis*, meaning in Latin “to stand on decided cases.” Under this doctrine, judges are encouraged (but not forced) to stand by precedents. According to Judge Richard Posner:

Judge-made rules are the outcome of the practice of decision according to precedent (*stare decisis*). When a case is decided, the decision is thereafter a precedent, i.e., a reason for deciding a similar case the same way. While a single precedent is a fragile

thing . . . an accumulation of precedents dealing with the same question will create a rule of law having virtually the force of an explicit statutory rule.

Value of Precedent

Stare decisis provides several useful functions. First, consistency in the legal system enhances the ability to plan business decisions. Second, as a rule is applied in many disputes involving similar facts, people will be increasingly confident that the rule will be followed in the resolution of future disputes. Finally, the doctrine creates a more just legal system by neutralizing the prejudices of individual judges. If judges use precedent as the basis for decisions, they are less influenced by their personal biases.

Changes in Society

An advantage of dispute resolution through the common law is its ability to change with the times. As changes occur in technology or in social values, the common law evolves and provides new rules that better fit the new environment. Although most cases are decided on the basis of stare decisis, judges are not prohibited from changing legal principles if conditions warrant. A judge may modify or reverse an existing legal principle. If that decision is appealed to a higher court for review, the higher court may accept the new rule as the one to be followed.

In recent years, there have been rapid changes in the manner in which we can communicate with one another. While the mail dominated in the past, businesses now use faster communications systems to be competitive. E-mail and faxes have often replaced the former method of personally signed documents. The law adapted to accept new communication methods.

JURIS



prudence?

Creative Common Law

An 18-year-old high school student in California “earned” over \$1 million in a stock scam. When the federal authorities busted his operation, charged him with securities fraud, and made him repay his earnings, he was also booted off his high school baseball team.

He then sued his high school for \$50 million. The basis of his suit was that he had planned to be a major league baseball player, but now that he could not play on his high school team, he could not perform in front of baseball scouts who would draft him into the pros.

Source: *True Stella Awards*

The Executive

In addition to being the one who signs (or vetoes) bills passed by Congress, the president is another source of law. The president can create law by issuing *executive orders*, requiring federal agencies to do certain things within the president’s scope of authority, such as an order to give preference to buying recycled products or to restrict financial transactions by suspected terrorist organizations.

The president can also influence the degree to which administrative agencies undertake their duties and responsibilities. One administration may not pursue environmental, antitrust, or international trade regulation as strongly as another administration. Thus, some industries may face a more hostile legal environment under one administration than under another.

International Sources of Law

Companies doing business in other countries must be as concerned with additional laws. The principal sources of international law affecting business include the laws of individual countries, the laws defined by treaties and trade agreements among countries, and the rules enacted by multinational regional or global entities—such as the World Trade Organization.

Article II, Section 2, of the U.S. Constitution requires approval by two-thirds of the Senate before a treaty (international agreement) agreed to by the president becomes binding on the U.S. Treaties of significance to business include the United Nations Convention on Contracts for the International Sale of Goods (which can govern the sale of goods between parties from different countries), which we discuss in Chapter 11, and the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (which assists in the enforcement of arbitration clauses in international contracts). Treaties and other laws particular to the international legal environment are discussed in Chapter 21 and at various points in other chapters.

CLASSIFICATIONS OF LAW

The organization of law can be thought of in several ways, such as whether it originated from a constitution, a legislative body, or the judiciary. The more common classification systems, however, classify law on the basis of whether it is: 1) public or private, 2) civil or criminal, or 3) procedural or substantive. Laws may fall into more than one classification. For example, the sale of automobile insurance is affected by private law (a contract between the company and the buyer) and public law (state regulation of insurance, which could result in civil or criminal penalties for insurance sellers who break state law).

Public and Private Law

Some examples of public and private law are provided in Exhibit 1.3. Public law is concerned with the legal relationship between members of society—businesses and individuals—and the government. Public law includes statutes enacted by Congress and state legislatures and regulations issued by administrative agencies. It influences the behavior of members of society and brings about social change.

Private law sets forth rules governing the legal relationships among members of society. It helps to resolve disputes and to provide a way for the values and customs of society to influence law. Private law is primarily common law and is enforced primarily through the state court systems. Unlike public law, which at times makes major changes in legal rules, private law tends to be quite stable and changes slowly.

Exhibit 1.3

Examples of Public and Private Law**Public Law**

- Administrative Law
- Antitrust Law
- Bankruptcy Law
- Constitutional Law
- Criminal Law
- Environmental Law
- Labor Law
- Securities Regulation

Private Law

- Agency Law
- Contract Law
- Corporation Law
- Partnership Law
- Personal Property
- Real Property
- Torts

Civil and Criminal Law

When a legislative body enacts a law, it decides whether the law is to be civil, criminal, or both. Unless a statute is designated as criminal, it is considered civil law. Examples of civil and criminal law are provided in Exhibit 1.4.

Criminal law concerns legal wrongs or crimes committed against the government. As determined by federal or state statute, a crime is classified as a *felony* or a *misdemeanor*. A person found guilty of a criminal offense may be fined, imprisoned, or both. To find a person guilty of a crime, the trial court must find that the evidence presented showed *beyond a reasonable doubt* that the person committed the crime. The severity of punishment depends in part on whether the offense was a felony or a misdemeanor. Generally, those offenses punishable by imprisonment for more than a year are classified as felonies. Misdemeanors are generally less serious crimes, punishable by a fine and/or imprisonment for less than a year.

While criminal laws may be called crimes against the state, most of the cases involve actions against private individuals, not against the government directly. For example, the accounting firm Arthur Andersen was accused of criminal violations for its role in the Enron financial scandal. While those convicted of a criminal offense may be required to pay restitution to the victims of their crimes, the primary purpose of criminal law is not victim compensation, which may be left to civil litigation, but to deter and punish certain behavior.

Civil law is concerned with the rights and responsibilities that exist among members of society or between individuals and the government in noncriminal matters. A person or business found liable for a *civil wrong* may be required to pay money damages to the injured party or to do or refrain from doing a specific act or both. In finding the wrongdoer liable, the jury (or the judge in a nonjury trial) must find that the *preponderance* (majority) of the evidence favored the injured party.

Substantive and Procedural Law

Substantive law includes common law and statutory law that define and establish legal rights and regulate behavior. Procedural law determines how substantive law is enforced through the courts by determining how a lawsuit begins, what documents need to be filed, which court can hear the case, how the trial proceeds, and so on.

A criminal case, for example, must follow criminal procedural law. The appropriate appellate procedure must be followed when a lower-court decision is appealed to a higher court for review. Similarly, agencies enforcing administrative laws and regulations must follow appropriate procedures. While most of our focus will be on substantive law, it is important to keep in mind that proper procedure must be followed by all participants in the formal legal system. Examples of substantive and procedural law are provided in Exhibit 1.5 on page 16.

Exhibit 1.4**Examples of Civil and Criminal Law****Civil Law****Contract Law**

Auto Repairs
 Buying Airline Tickets
 Forming a Business
 Sale of Clothing
 House Insurance

Tort Law

Assault and Battery
 Defamation
 Invasion of Privacy
 Medical Malpractice
 Trespass

Criminal Law**Misdemeanor Offenses**

Assault and Battery (Simple)
 Disturbing the Peace
 Larceny (Petit)
 Public Intoxication
 Trespass

Felony Offenses

Burglary
 Homicide
 Larceny (Grand)
 Manslaughter
 Robbery

INTERNATIONAL**Perspective****Sources of Law in Japan**

An important member of the civil-law family of nations is Japan, which adopted much of the German civil-law legal system in the late 1800s to be more attractive to Western businesses. Like its civil-law counterparts, Japan's basic source of law is its codes. In contrast to common-law systems where many basic laws are developed by judges, civil-law codes are enacted by the government—in Japan, the Diet, or national parliament. The codes arrange categories of law in an orderly and comprehensive way. In Japan, the basic codes are the Civil Code, the Commercial Code, the Penal Code, and procedural codes such as the Code of Criminal Procedure and the Code of Civil Procedure.

To illustrate, under common law, judges have developed rules in tort law imposing liability for intentional and negligent acts. Article 709 of the Japanese Civil Code is quite similar. It states:

A person who violates intentionally or negligently the right of another is bound to make compensation for damages (for injuries to the person, his liberty, or reputation as well as his property) arising therefrom.

The Japanese courts apply codes very strictly. The application of a code provision to a dispute is influenced by past applications, particularly those of the highest courts. Because the Japanese rely more on informal dispute resolution, many parts of the codes have not been litigated. In such situations, Japanese lawyers rely on interpretations of the codes by legal scholars. If no specific code provision applies to a dispute that has arisen, the court may look to traditions in reaching a decision, or it may apply a code provision intended to apply to another type of dispute. Through this process—and the enactment of new code provisions by the Diet—Japan's civil-law legal system adjusts to social, economic, and technological changes.

ETHICS AND BUSINESS

The public image of business has been slipping for decades. According to a poll conducted in 1966, 55 percent of the American people had a "great deal of confidence" in American business executives. In recent years, that percentage has dropped to about 20 percent. Surveys indicate that confidence in business leaders is low—especially with regard to honesty and ethical standards. (Confidence in political leaders and institutions is even lower.)

One possible explanation is that ethical standards have fallen. After all, 75 percent of college students admit to some form of cheating and 79 percent of employees