





COMPREHENSIVE BUSINESS LAW

Principles and Cases



**Daniel V. Davidson
Brenda E. Knowles
Lynn M. Forsythe
Robert R. Jespersen**



Comprehensive Business Law Principles and Cases

Daniel V. Davidson

Radford University

Brenda E. Knowles

Indiana University at South Bend

Lynn M. Forsythe

California State University, Fresno

Robert R. Jespersen

University of Arkansas at Little Rock



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Note to the Student

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To Dee, who made it possible

To my parents, Madge L. and Ernest E. Knowles

To James M. Poptanich and Vicky L., Aileen B., and Robert J. Zollwag

To Shirley

About the Authors

DANIEL V. DAVIDSON received both his B.S. and his J.D. degrees from Indiana University. He has taught at Central Connecticut State College, St. Cloud State University in Minnesota, the University of Arkansas, and California State University at Fresno. He is currently serving as the Chairman of Accounting, Finance, and Business Law at Radford University in Virginia.

Professor Davidson has been the recipient of four different awards for teaching. In 1975 he was named Outstanding Teacher of the Year at Central Connecticut State College. In 1979 he received the Outstanding Faculty Award from Beta Alpha Psi, and in 1980 he was named the Razorback Award winner as the Outstanding Business Professor, both at the University of Arkansas. In 1984 Professor Davidson was awarded the Meritorious Performance Award at California State University, Fresno.

Professor Davidson is an active member of the American Business Law Association and its Southern and Western regionals. He has held each of the offices of the Southern Region, most recently serving as president for the 1982–1983 term.

BRENDA E. KNOWLES received a B.A. *magna cum laude* from the University of Evansville, an M.A. from Miami University, and a J.D. from the Indiana University School of Law. She is Associate Professor of Business Law at Indiana University at South Bend, where she has been the recipient of a system-wide, all-university teaching award, the Amoco Foundation Excellence in Teaching Award. She is also an associate with the Danforth Foundation, which encourages effective teaching and seeks to humanize teaching and learning in the academic community, and is a member of Beta Gamma Sigma.

Professor Knowles specializes in research on employment discrimination, antitrust law, and intellectual property law. She publishes her work in professional journals and recently won an award for her research. She has also been recognized both nationally and locally for her professional and civic accomplishments.

Professor Knowles is an active member of the American Business Law Association and various regionals. Having previously held each of the other offices of the Tri-State Regional, she served as president of that association in 1986–1987. Licensed to practice law in Indiana, she is a member of the American, Indiana State, and St. Joseph County Bar Associations.

LYNN M. FORSYTHE is Professor of Law and Director of Graduate Business Programs at California State University, Fresno. She received her B.A. from The Pennsylvania State University and her J.D. from the University of Pittsburgh School of Law and is licensed to practice law in both California and Pennsylvania.

Professor Forsythe has been an estate and gift tax attorney for the Internal Revenue Service and has taught business law, administrative law, government regulation of business, and estate planning. She is the author of numerous articles on business law and the teaching of business law. She is also a co-editor for *The Journal of Legal Studies Education*.

Professor Forsythe is a member of Beta Gamma Sigma; the American Bar Association, for which she chaired subcommittees and panels; the American Business Law Association, for which she served as program coordinator for the 1983 annual meeting and as liaison to the National Conference of Commissioners on Uniform State Laws; and the Western Business Law Association, which she has served as an officer, most recently serving as its president for the 1985–1986 term.

ROBERT R. JESPERSEN is Professor of Business Law at the University of Arkansas at Little Rock, where he has served as associate dean of the College of Business Administration and as director of the M.B.A. Program and of the Executive Development Program. He holds A.B. and A.M. degrees from Columbia University and a J.D. from the University of Houston.

Professor Jespersen has practiced law in both Texas and Arkansas. He has served as Assistant Attorney General of Texas and has been a member of the faculty of the University of Houston and an administrative officer at Columbia University and Princeton University.

Professor Jespersen served three years in Africa, first as headmaster of the Kurisini International Education Center in Dar es Salaam, Tanzania, and then as senior advisor to the Association of African Universities in Accra, Ghana. He is a former president of the Southern Regional Business Law Association and is a member of Beta Gamma Sigma. He is currently serving as an officer of the American Business Law Association.

Preface

Law cannot be made simple, nor can it be made easy. However, it is our strong conviction that law does not have to be made any more difficult than it already is, and it is on that premise that we have written this basic text for undergraduate students. The purpose of *Comprehensive Business Law: Principles and Cases* is to make the myriad topics of business law comprehensible to the beginning student by using plain language, relevant and realistic examples, pertinent cases, and an easy writing style. While we do not intend to familiarize students with all the technical intricacies of the law, we do hope to stimulate their interest in those intricacies and to make them aware of how the law affects their lives.

No matter what discipline a business student selects as a major field of study, that student will encounter many legal issues during his or her professional life. A substantial number of those issues will undoubtedly fall within the areas covered in this text—among them, contracts, sales, commercial paper, debtor-creditor relations, agency, partnerships, corporations, government regulations, property protection, and international business. This text cannot supply the solutions to all the potential legal problems involved in these areas, but it can help one in recognizing the legal issues that such problems present and in deciding when to seek the appropriate help. The study of this book will not make anyone into a lawyer, but it should make one aware of when a lawyer is needed.

The book is divided into ten parts, with the divisions based on the traditional topical areas of business law. Such an approach allows the instructor to select those topics germane to any course in which the text is used. It is suitable

STATEMENT OF PURPOSE

ORGANIZATION

for use in a single-semester, comprehensive-coverage course or as the text for a multiple-semester, sequential series of courses. While the text is not specifically geared to the CPA examination, it does cover each of the business law topics included in the examination, and thus should be of considerable value to the accounting major.

Part I, "Foundations of American Law," introduces the student to the American legal system by examining the logic behind the law and the reasons for studying business law. Chapter 2 explains the structure of the court system and the place of the United States Constitution in our legal system. Chapter 3 introduces *tort law and the concept of private duty*. Chapter 4 focuses on the area of criminal law and the concept of public duty. The next chapter is an unusual and distinctive feature of the book. It leads the student, step by step, through the stages of a civil lawsuit, with explanations of *what* is being done at each stage of the proceedings and *why* it is being done. Chapter 6 is also distinctive, exposing the student to two professional relationships: the attorney-client relationship and the legal liability of the accountant.

Part II deals with the topic that forms the foundation of business law: the law of contracts. Although the modern complexities of business have led to a number of specialized areas of law, contract law forms the base upon which these specialized areas are built. A sound understanding of contract law is therefore essential to an understanding of the various other areas of business law. Chapter 7 explores the development of contract law and the different classifications of contracts. Chapter 8 looks at the formation of the agreement between the parties—the area of offer and acceptance. Chapter 9 discusses the concept of consideration—the exchange of value between the parties that makes the contract enforceable. Chapter 10 points out the limitations on who can enter a contract—the concept of capacity. Chapter 11 focuses on illegal agreements, underscoring the requirement that to be valid, a contract must have a legal purpose. Chapter 12 examines the voluntary nature of the contract—the concept of reality of consent. Chapter 13 looks into the occasional need for formality in contract law and the need for a written agreement. Contracts between two parties often affect the rights of a third person not a party to the contract; Chapter 14 explores some of the rights—and duties—of the third persons so affected. Chapters 15 and 16 deal with the release of some contract obligations, or discharges, and the remedies available for nonperformance of other contract obligations.

Part III, "The Law of Sales," introduces the Uniform Commercial Code (UCC), the modern, comprehensive law that governs many commercial transactions. Although any contract for the sale of goods falls within Article 2 of the UCC, very few people are aware of their rights and duties in this area. Merchants need to be especially cognizant of the different legal aspects of sales law. Of special interest and growing importance are warranties and product liability, which are the subject of Chapter 20. The recent consumer movement has made both these areas particularly important to any business that deals in goods.

Commercial paper, which is the focus of Part IV, is another area governed by the UCC. Millions of checks are issued every week to pay bills, to purchase goods and services, or to receive cash. Every loan made involves the use of some type of promissory note. Both checks and promissory notes are types of commercial paper, and both are governed by Article 3 of the UCC. Knowing how and when to use a negotiable instrument can be extremely important to a business, especially in terms of profit generation and liability.

Part V, "Debtor-Creditor Relations," offers a more comprehensive coverage of this subject than that offered in any other business law text we have seen. Three detailed chapters are devoted to secured transactions; two chapters focus on bankruptcy and alternatives to bankruptcy. We have given these topics such extensive coverage for several reasons. These are two of the most difficult areas in business law to master, and the extra coverage allows us to go into greater detail in our explanation, resulting in a better treatment of the fundamental concepts. The breakdown of secured transactions into three chapters emphasizes the major stages of a security interest from creation through enforcement. The breakdown of bankruptcy into two chapters emphasizes the alternative nature of the options available to the debtor. Chapter 30 deals with the Bankruptcy Reform Act, the Bankruptcy Amendments and Federal Judgeship Act of 1984, and the general concepts of a "straight" bankruptcy under Chapter 7. This chapter also explains why the Bankruptcy Reform Act was declared unconstitutional and how the 1984 Amendments have clarified this area of law. Chapter 31 examines the alternatives to a "straight" bankruptcy, both within bankruptcy law and under traditional state laws.

Part VI devotes three chapters to a very important area of business law: the law of agency. Agency is a specialized type of employment in which one person is authorized to represent another in business transactions. Without the law of agency, modern business as we know it would be impossible. Thus, a thorough knowledge and understanding of this area is of special importance to a business student. We decided not to combine agency with the general topic of employment for two reasons. First, agency is an important enough topic to stand alone. Second, nonagency employment is primarily an aspect of contract law, a subject covered earlier in the text, and as such is controlled by government regulation, which is the focus of Part VIII.

Part VII, "Business Organizations," consists of nine chapters. The first three examine the partnership as a business form: its formation, operation, and termination. Chapter 37 provides a detailed discussion of the problems involved in winding up this particular type of business. The next six chapters deal with many aspects of the corporation as a business form. Included are chapters on the formation of a corporation, the operation of the business, and the management of the firm. Also included is a timely chapter that explains the effects of mergers, consolidations, and other acquisitions of the corporation. The last two chapters in Part VII treat the topics of franchising—another timely subject—and securities regulation. Because so many

corporations use securities as a source of funds, familiarity with securities regulations is an important consideration in avoiding liability for securities fraud. The Foreign Corrupt Practices Act, partially enforced by the Securities and Exchange Commission, is included in the coverage of this topic.

Part VIII, "Government Regulations," is another unique feature of the text. It not only covers the major antitrust statutes but also explains the theories that justify government regulation of business. Also included are chapters on consumer and environmental protection, one of the most controversial areas of modern business law, and labor and fair employment practices. The chapters in Part VIII deal comprehensively with the environment within which all American businesses must operate, and an awareness of these issues is essential to a successful business career.

Part IX, "Property Protection," examines a number of diverse, yet related, topics: real and personal property, bailments, insurance, wills, estates, and trusts. These chapters provide the student with some of the basic information needed to protect personal assets. Chapters 48 and 49 deal with the acquisition, transfer, and protection of personal and real property. Chapter 50 covers the topic of insurance, the protection of that property from hazards. Wills, estates, and trusts—the planning of an estate to provide for one's heirs and family—are the subjects of Chapters 51 and 52.

Part X is another unique feature of our text. This section, "The Emerging Business Environment," discusses the topics of international business, business ethics, and computers and the law. Our intent here is merely to provide an overview of these increasingly important areas, which promise to have a substantial impact on the future path of business and of business law. Thus, although the coverage of any single issue is limited, the overall treatment effectively introduces each of the topics.

Multinational corporations present special problems—and special opportunities—for the future, and some awareness of the legal issues to be faced in this area will be extremely important for the successful business person of the future. In a similar way, the topic of business ethics will present special problems and special opportunities in the future. As society increases the demands it makes upon corporations, the business leaders of the future will need to respond to these demands or face ever-increasing government regulation. The pervasive nature of computers in our world justifies a separate chapter dealing with the topic of how computers and the law must interrelate.

CHANGES IN THE ORIGINAL TEXT

Originally, we wrote the text *Business Law: Principles and Cases* using a briefed case approach. A number of our reviewers liked the text but preferred edited cases to the briefs. This version of the book, which is now in its second edition, was designed to satisfy that preference. We have made some changes in the text to improve our coverage and to make the book an even better teaching/learning tool. Throughout the book we have replaced cases, selecting cases that are more recent and also selecting cases that illustrate a particular topic better than the cases being replaced. We have added five case problems

to the end-of-chapter materials and broken this material into two distinct categories, discussion questions and case problems. In so doing, we hope to provide a greater range of material for those people who utilize the end-of-chapter materials in class or as study tools.

The law of bankruptcy changed in 1984, and our coverage of bankruptcy has been totally modified to reflect these changes. Of special interest here is the new pro-creditor approach of the new bankruptcy coverage. We have also added chapters dealing with business ethics and with computers. These two areas promise to offer much legal controversy in the years ahead.

The Test Bank has been improved and upgraded, providing instructors with numerous options and a larger number of potential questions. There are also more transparencies, together with some new, more illustrative replacement transparencies.

We feel that these changes make an already strong text even stronger.

Chapter Outlines

The topical outlines that begin each chapter alert the student to what the chapter will cover and help to provide a structured study approach.

PEDAGOGICAL DEVICES

Marginal Notes and Glossary

Brief, semitechnical definitions for key terms appear in the margins throughout the text. These marginal notes are not intended to be complete definitions, but rather to provide a working understanding of the phrases without disrupting the student's efforts to read the material. More complete definitions are provided in the Glossary, and the student may also want to consult a law dictionary for even more detail.

Cases and Case Index

The text uses numerous cases to illustrate a variety of legal points. These include both classic, landmark cases and many of the most recent decisions pertaining to business law. The actual court opinions have been edited slightly to make the cases of an appropriate length for the text and to allow for a focusing on the issues that pertain to the legal issues being illustrated. We have, however, retained the "flavor" of the cases by retaining the actual judicial language of the opinion. In so doing, the student will have the opportunity to follow the reasoning of the justices who wrote the opinions and to experience the challenge of interpreting the language of the justices in applying the opinion of one case to a later, similar fact situation. We have also attempted to fit the chapter to the cases, rather than forcing the cases to fit into the chapter. As a result, some chapters will have more cases, and some will have less. We have attempted to provide a consistency in *length* of case coverage, rather than in the absolute number of cases contained in each chapter. The Case Index at the end of the book allows the reader easy

access to this material. A number of hypothetical cases intended to illustrate particular points of law also appear in several places throughout the text.

Illustrations

The text includes many helpful illustrations—flowcharts, diagrams, legal forms and documents, summary and comparative tables. A list of these follows the table of contents.

Summaries

The text of each chapter closes with a narrative summary of the material presented in the chapter. The summaries are not meant to completely cover the material, but rather to aid the student in a general review.

Questions and Case Problems

Each chapter ends with a number of questions and problems, some dealing with the principles and terms covered in the chapter and some designed to test general comprehension of the material. Most chapters include case problems that are based on actual court opinions. Since these problems give the case names and citations, students can look up the actual cases to compare their answers and reasoning with those of the court. These chapter-ending questions and problems can be used as a study tool in reviewing the material, as classroom discussion material, or for out-of-class writing assignments.

Appendixes

Two appendixes provide easy access to actual source material referred to in text discussions and in footnotes throughout the book. Appendix A includes Articles 1–9 of the *Uniform Commercial Code*; Appendix B presents the United States Constitution.

SUPPLEMENTAL ITEMS

Study Guide

Elizabeth Crocker and Ann Henry, both of the University of Arkansas, have prepared a comprehensive Study Guide to accompany the text. This Study Guide contains materials designed to help the student master the subject and its vocabulary.

Instructor's Manual

The Instructor's Manual outlines each chapter's material in the form of teaching hints. A segment called "Trouble Spots" highlights those areas that traditionally confuse students because of the complexity of the material or the language of the law. This section suggests methods of avoiding these traditional problems by calling the student's attention to them in advance. The *Instructor's Manual* also includes answers to the text's chapter-ending questions and problems.

Transparencies

A set of more than fifty acetate transparencies is available to help instructors graphically illustrate some of the more difficult concepts presented in the text. These consist for the most part of illustrations not contained in the text; they include summary charts, legal documents, and various other facsimile items.

Test Bank Booklet and Computerized Test Banks

For each chapter of the text, the Test Bank provides the following types of questions: ten true-false, aimed at both application and vocabulary; five multiple choice, aimed primarily at application; five matching, with seven possible matches, so that the process of elimination is largely excluded; and one short essay or discussion question. This mix provides sufficient flexibility and enough possible questions to satisfy the needs of most instructors. A computerized test bank of the same items is also available.

Trying to put a textbook together “from whole cloth” is difficult under the most ideal of conditions. To do so when geographically separated is even more difficult, and we could not have done it without the help, support, encouragement, and belief of the following people:

A STATEMENT OF GRATITUDE

Dick Crews, our executive editor and emotional guru. His help and encouragement from day one were invaluable, and his enthusiasm provided the necessary adrenaline whenever we began to tire.

Diane Miliotes, Dick’s assistant editor and strong right hand. Diane was always there with the details, correspondence, and communications necessary to coordinate our multiregional writing efforts.

Pamela Rockwell, our production editor, who managed to take our individual quirks and grammatical eccentricities and turn them into a well-written textbook, and did so with never (well, hardly ever) a complaint voiced to us.

We also wish to express our gratitude to The American Law Institute, which granted us permission to reprint excerpts from the *Restatement (Second) of Contracts* (copyright 1982 by The American Law Institute; reprinted with the permission of The American Law Institute), *Restatement (Second) of Torts* (copyright 1977 by The American Law Institute; reprinted with the permission of The American Law Institute), and *Restatement (Second) of Agency* (copyright 1958 by The American Law Institute; reprinted with the permission of The American Law Institute).

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Mountain View College

These individuals read our first submissions and offered constructive criticism to strengthen the finished product. They then reviewed and critiqued our revisions. Throughout, they were critical, supportive, and encouraging. Their efforts and inputs were essential to the final product.

A NOTE TO THE STUDENT

As you read this text, you may find yourself occasionally frustrated by the use of such terms as *generally*, *usually*, *ordinarily*, *in most cases*, *as a rule*, and the like. When that happens, remember this: most business law is based on state law, and there are many variations among the several states. These variations make it impossible—and unwise—to make definite statements about some legal subjects. In addition, although there *are* general rules of law, there are also exceptions to the general rules. Since space and time limitations would make it impossible to list all these exceptions in any one introductory text, we have gone with the majority rule unless otherwise noted.

Also remember that if these generalities are frustrating for you, they are equally frustrating for your instructor, for attorneys who are arguing these principles in the various courts of the land, and for the judges who have to decide the cases being argued!

It is our sincere hope that we have put together a text that is not only a valid educational tool but also a book that is enjoyable to read. Business law is a serious and important topic, but it is also a potentially entertaining and interesting one. This book is designed to emphasize the importance and seriousness of the topic while underscoring the interest it contains. We feel that we have been successful in our efforts, and we hope that you agree.

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