# PRINCIPLES OF BUSINESS LAW

Twelfth Edition

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# Preface

In preparing this twelfth edition of *Principles of Business Law,* we were cognizant of the many changes that have occurred in business law since Essel Dillavou and Charles Howard prepared the first edition over fifty years ago. In the intervening half-century, the content of the book has been greatly influenced by numerous developments in the law, such as the adoption of the Uniform Commercial Code and the changes brought about by cases decided under the Code. In the late 1950s the field of business education was under scrutiny, and the studies made during those years had significant impact on business law as a discipline and on the content of this textbook. Today, most business law courses are concerned with the legal environment of business as well as with traditional business law subjects. Indeed, many departments of business law have been renamed departments of "legal studies," as the subject matter taught has expanded to cover government regulation of business in addition to commercial law. This text has been significantly "environmentalized" in the past, in order to meet the standards of the American Assembly of Collegiate Schools of Business. Earlier editions began to reflect the changing needs of business managers.

Perhaps no discipline in business schools has as much impact on business law and the study of the legal environment as does accounting. While law courses are designed to meet the needs of all business students, they are of special importance to accounting majors because of the CPA examination. As a result of the influence of business school faculty, course offerings in business law not only prepare students for careers in business but also give them the capability of passing examinations such as those for the CPA or CLU.

The increase in government regulation of business and its high place in the education of business students impacts on accounting as it does on all other disciplines. For various reasons, many accounting faculties have tried to limit the number of hours devoted to business law. Often they have sought to add the legal environment subject matter to the traditional courses without any increase in student contact hours. Sometimes they have proposed deleting subject matter to make the courses fit into an existing curriculum. Fortunately, in 1978 the Ameri-

can Institute of Certified Public Accountants examined this problem and issued a policy statement with detailed recommendations for business law and legal environment courses.

This AICPA statement of policy, entitled *Education Requirements for Entry into the Accounting Profession,* allocated sixty semester hours to general education, of which three were assigned to the legal and social environment of business and six to traditional business law. This edition of *Principles of Business Law* is designed to provide materials for these nine hours as well as to meet the AACSB core requirement. The material could be offered in two courses if desired, especially if some of the topics are omitted.

The AICPA description of the legal and social environment of business recognizes that the course essentially deals with government regulation of business. To provide materials for such a course, part I includes chapters on constitutional law, administrative law, antitrust law, and the law and employment. The chapter on criminal law has increased coverage of white-collar crime. A chapter on the theories of tort liability is followed by one on products liability. This change recognizes the overwhelming importance of the tort theory of strict liability in products liability litigation and the fact that such litigation is perhaps the most important of the consumer protection remedies available. Material for the introductory course includes a study of the court system, sources of law, and alternatives to litigation for resolving disputes. The first ten chapters can be used for the first of the three courses described by AICPA. If more material is required, the chapters dealing with consumer and debtor protection could be covered as a part of the first course.

The AICPA standards of the two additional courses in business law include the following topics: contracts, agency, commercial paper, sales, property and wills, estates and trusts. Each of these topics is covered in chapters 11 through 45. In addition, there is substantial coverage of bankruptcy, secured transactions, and business organizations.

This edition is divided into seven parts. Pertinent cases are grouped at the end of each chapter. Throughout the book, these cases are footnoted, so that the instructor may assign as many as desired. There are 251 such cases, or an average of six per chapter. Of the 251 cases, 192 are new to this edition. More than half of these new cases were decided in 1980 and 1981. In recent years, courts have tended toward more "social engineering" and have developed new theories and new approaches to old problems, making it very important for students to study the most recent cases. Moreover, students "relate" more to modern cases than to old cases, however sound and well-written the older ones may be.

Throughout the text, we illustrate that the law is in a state of constant change and that the dynamic quality of the law is its ability to adapt to changing conditions. For example, one of the important chapters in contracts deals with public policy contract defenses.

Recognizing that people in business have educational needs different from those of lawyers, we try to meet the requirements of businesspeople by stressing 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 will have to be familiar with the legal aspects of business problems.

We have deleted most of the procedural issues from the cases and have omitted case references and footnotes. Since we believe that students should be required to study the language and reasoning of the courts on substantive issues, we include those portions of the cases that show the arguments of each party and the court's resolution of the issues raised. We have avoided long cases; but since case study makes a substantial contribution to the student's education, the cases are long enough to provide a good vehicle for class discussion.

Corley and Robert find that their new co-author is the most significant change in this edition. Professor Eric M. Holmes of the University of Georgia brings many new ideas and insights to the study of contracts and the Uniform Commercial Code, areas in which he is nationally recognized as a leader in legal education. He lectures throughout the country and writes extensively on these subjects. Professor Holmes received his J.D. from the University of North Carolina at Chapel Hill in 1969, his L L.M. from Columbia in 1975, and his S.J.D. from Columbia in 1981.

Professor Holmes prepared the contracts and UCC portions of the text. His material on contracts (part II) is naturally designed to give the student an understanding of the basic and traditional concepts of contracts as well as recent developments of the closely related law of "sales" under the Uniform Commercial Code. Since the UCC and traditional contract law totally intersect at the offer and acceptance stage, they are treated as a "unified" body of law to avoid duplication. The Uniform Commercial Code, including Revised Article 9, is attached to the text as an Appendix, and appropriate sections are referred to in brackets within the text, for easy reference. Part II is organized in a logical sequence, as typical contract disputes arise; that is, starting with forming the contract (offer and acceptance), to validating the contract (consideration), to attacking the contract (defenses), to performing it (performance and breach). We believe this approach to be unique and, from our experience in the classroom, logically and practically helpful to students. In this and other parts, we introduce some vital concepts and information about economic regulation generally.

Part III is devoted to the Uniform Commercial Code. Without repeating those points emphasized under the law of contracts, it covers the traditional sales, commercial paper, and secured transactions. The discussion of commercial paper places increased emphasis on the liability of parties (especially banks) in transactions involving commercial paper. It also recognizes the decreased importance of the "holder in due course" concept, now that the 1976 FTC regulation significantly protects consumer defenses against finance companies and other transferees. Because of the recent proliferation of security problems for creditors and sellers of goods, three chapters now cover secured transactions. Emphasis is placed upon priority disputes between the secured party under Article 9 and other claimants, including the bankruptcy trustee. Since the Revised Article 9 of the Code has been enacted in over 25 states, with passage in the remaining states likely in the near future, the revision receives special attention along with the original version.

Part IV contains four important chapters that deal with the law as it relates to creditors and debtor consumers. Chapter 28 is a logical extension of secured transactions under the Code. It covers the use of real property as security for

debts. Chapter 29 deals with other methods of protecting creditors, such as suretys and guarantors. Chapter 30, the special chapter on the laws assisting debtors and consumers, gathers in one place much of the recent legislation aimed at protecting consumers. It points to the trend from "let the buyer beware" to "let the seller beware." Chapter 31, "Bankruptcy," is written to give students a thorough understanding of bankruptcy law in practice as well as in theory, to make students aware that bankruptcy is an uncomplicated, common proceeding in which debtors are able to keep a substantial amount of their property while ridding themselves of debts. It also gives a prominent place to adjustment and reorganization proceedings.

Part V discusses property—personal property, bailments, real estate transactions, wills, estates, and trusts—with special attention to transactions involving property. Studying property law from a transactional approach is of immediate practical value.

Part VI, "Agency," covers the subject in three chapters. Chapter 36 explains terminology, creation, and termination of relationships. The other two chapters deal with agency and the law of contracts and the law of torts. Chapter 38 points out the important role that *respondeat superior* plays in our legal system.

Part VII discusses business organizations in three stages. In addition to the factors used in selecting the form of organization, these stages are (1) the method of creation of the various forms of organization, (2) the legal aspects of operating the various forms of organization, and (3) the law as it relates to dissolution of business organization. Special types of business organizations, such as the Sub-Chapter S corporation and the professional service association, are explained.

Barbara George has written a student workbook to accompany the text. We know that many students will benefit from its use, and we want to express our appreciation to her for its preparation. We want to thank Professor Peter Shedd of the University of Georgia for assisting in the preparation of the test bank. He brought valuable expertise based on a successful teaching career.

The authors would also like to acknowledge the assistance of those who reviewed the manuscript and provided many helpful suggestions: Professor Donald R. Brenner, The American University; Professor Arthur Galub, Bronx Community College; Professor Dagmar V. Halamka, El Camino College; Dean Howard Lapidus, Queensboro Community College; Professor Arthur M. Levine, California State University, Long Beach.

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RNC, EMH, WJR

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# law

Each of the seven parts of this book covers a subject of the law that relates to business and the environment in which business operates. We shall look at the legal environment of business and at traditional business law subjects, such as contracts and business transactions.

Part I gives us a background, an understanding of our legal system. We find out where our laws come from, how they are applied, and how they are changed. Separate chapters cover the judicial system and litigation. Arbitration as a substitute for litigation is the major subject matter of another chapter, and there is detailed coverage of the law of torts (private wrongs) and criminal law (public wrongs) as they pertain to business.

Now, more than ever before in our nation's history, law controls business. Laws written to solve many of society's problems are directed at business, regulating its activity and its decisions.

Solutions to many of society's problems are found in laws, especially those regulating business activity. Our attempts to retain a competitive economic system depend on laws generally known as the antitrust laws. The basic approach to solving the problems of air and water pollution is found in the law. To provide equal employment opportunity, the law now has a significant impact on hiring, promoting, and discharging all employees. In the field of consumer protection, laws regulate the debtor-creditor relationship. Because of the importance of the law as a scheme of social control of the business community, four chapters in Part I discuss the legal environment in which business is conducted. These chapters dealing with government and business are the foundation for our study of business law and the way we shall see it applied to business transactions.

### *1. Definitions of law*

Our view of the law will be a broad one, and our first question will be: What is law? In everyday conversation, people use the world *law* in many different ways, but it is a word that is very difficult to define. In its broad context it expresses a variety of concepts. Law has been defined as 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 difinition.

In attempting to define *law,* it is helpful to look at its purposes or functions. 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, as in a suit for breach of contract. It is important that one 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.

In one sense, all issues and disputes in our society—political, social, religious, economic, or otherwise—ultimately become legal issues to be resolved by the courts. Thus it can be said that law is simply what the courts determine it to be as an expression of the public will in resolving these issues and disputes.

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.

Another view of law is that it is a method of social control—an instrument of social, political, and economic change. Law is both an instrument of change and a result of changes that take place in our society. The law brings about changes in our society; society brings about changes in the law. The law—responding to the goals, desires, needs, and aspirations of society—is in a constant state of change. Sometimes the law changes more rapidly than does the attitude of the majority of society. In this event, the law and our legal system provide leadership in bringing about changes. At other times our society is ahead of the law in moving in new directions, and changes in the law are brought about by the people. In the field of ecology, for example, various groups have put pressure on legislators to clean up the air and water. As a result, laws have been enacted, requiring devices installed to control pollution. Here the public pressure resulted in the enactment of laws, and the law was a follower rather than a leader. It is important to note that the law is not static—that it is constantly changing and that the impetus for the changes may come from many different sources.

In still another sense, *law* has been defined as the rules and principles applied by the courts to decide controversies. These rules and principles fall into three categories.

1. Laws, including the federal Constitution and state constitutions, that have been passed by legislative bodies.
2. Common law, or case law, derived from cases decided by the courts.
3. Procedural rules, which determine how lawsuits are handled in the courts and include matters such as the rules of evidence and related issues.

The first two elements provide the rules of substantive law that the courts apply, to decide controversies. The third provides the machinery whereby these rules of substantive law are given effect and applied, to resolve controversies.

While we are on the subject of definitions, we should point out that the pronoun *he* can mean "he or she," and we intend that inclusive meaning in almost every instance. In order to save the reader from tiresome repetition of the phrase "he or she," we use the common gender *he.*

### 2. 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. Reasoning by example, however, is at the heart of our judicial system.

In any case, "The life of the law has not been logic; it has been experience." In making this statement and in defining law as a prediction of what courts will decide, Justice Oliver Wendell Holmes stressed the empirical and pragmatic aspects of the law, its 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 it 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 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 found its way to America, in the Declaration of Independence: "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; it is also a set of rules for social control, and it grows 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.

### *3. Classifications of law*

As noted above, laws are sometimes classified as *substantive* or *procedural.* The law that is used to decide disputes may be classified as *substantive* law. On the other hand, the legal procedures that determine 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; procedural law established 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 concerned with relationship between individuals.

Public law may be divided into three general categories.

1. *Constitutional law* 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* is concerned with the multitude of administrative agencies, such as the Federal Trade Commission and the National Labor Relations Board.
3. *Criminal law* 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.

Private law is that body of law that pertains 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.

The law of contracts, for example, 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 areas such as agency and sales. A *tort* is a wrong committed by one person against another or against his property. The law of torts is predicated upon the premise that in a civilized society people who injure other persons or their property should 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 has purchased. The law of sales, even though a part of the law of contracts, contains several aspects that could best be labeled a branch of the law of torts. Therefore it is apparent that even the general classifications of contract and tort are not accurate in describing the subject matter of various bodies of law.

## Sources of Law

The unique characteristic of American law is that a very substantial part of it is not to be found in statutes enacted by legislatures but rather in cases decided by our courts. This concept of decided cases as a source of law comes to us from England. It is generally referred to as the *common law.* Our common law system of heavy reliance on case precedent as a source of law must be contrasted with civil law systems, which developed on the European continent. The civil law countries have codified their laws—reduced them to statutes—so that the main source of law in those countries is to be found in the statutes rather than in the cases. Under the common law system, of course, we have a large number of statutes and ordinances, but these are only a part of our law.

In the United States, common law has been the predominant influence. Since most of the colonists were of English origin, they naturally were controlled by the laws and customs of their mother country. But in Louisiana, and to some extent Texas and California, the civil law has influenced the legal systems, because these states were founded by French and Spanish peoples. It must not be overlooked, however, that much of the law in every state of the United States is statutory, and statutes are becoming increasingly important. Case law, or common law, remains an important source of law because of the extreme difficulty in reducing all law to writing in advance of an issue being raised.

In our system, statutes must be in keeping with the constitutions—federal and state—and the courts can declare void a statute that is found to violate constitutional provisions. Statutes and constitutions are sometimes classified as

*written law.* Also included under this heading are treaties that by the federal Constitution are also a part of the supreme law of the land. Case law, as opposed to written law, is not set forth formally but is derived from an analysis of each case that uncovers what legal propositions the case stands for. It is not proper to call this *unwritten law,* because it is, in fact, in writing. Case law, however, must be distinguished from statutory law in that it is not the product of the legislature but is rather the product of the courts. When a court decides a case, particularly upon an appeal from a lower-court decision, the court writes an opinion setting forth, among other things, the reasons for its decision. From these written opinions, rules of law can be deduced, and these make up the body of what is called case law or common law. The basic characteristic of the common law is that a case, once it is decided, establishes a precedent that will be followed by the courts when similar controversies arise later.

A third source of law is administrative law. Federal, state, and local administrative agencies make law by promulgating rules and regulations as well as by making decisions concerning matters under their jurisdiction.

In summary, our law comes from written laws such as constitutions, statutes, ordinances and treaties; from case law, which is based on judicial decisions; and from the rules and decisions of administrative agencies.

*4. Constitutions*

The federal Constitution is a grant of power by the states to the federal government, whereas the constitutions of the various states basically limit the powers of state government. In other words, the federal government possesses those powers *granted* to it by the states, and state governments possess reserved powers, all powers not taken away in the state consititution or specifically denied to them by the U.S. Constitution.

The Constitution of the United States and the constitutions of the various states are the fundamental written law in this country. A federal law must not violate the U.S. Constitution. All state laws must conform to, or be in harmony with, the federal Constitution as well as with the constitution of the appropriate state.

Two very important principles of constitutional law are basic to our judicial system. They are closely related to each other and are known as the *doctrine of separation of powers* and the *doctrine of judicial review.*

The doctrine of separation of powers results from the fact that both state and federal constitutions provide for a scheme of government consisting of three branches—legislative, executive, and judicial. Separation of powers ascribes to each branch a separate function and a check and balance of the functions of the other branches. The doctrine of separation of powers implies that each separate branch will not perform the function of the other and that each branch has limited powers. The system of checks and balances may be briefly summarized as follows:

SENATE: approves key executive and judicial appointments.

BOTH HOUSES: exercise control through power to appropriate funds and to limit or expand authority of the executive branch or the jurisdiction of the judicial branch in most cases.