Fundamentals of Business Law

FOURTH EDITION

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Preface

We are pleased to present this Fourth Edition of *Fundamentals of Business Law*. It is our intent that it be the most up-to-date coverage of traditional business law topics. We recognize that the students who use this text have needs far different from those of law students. Therefore, the text stresses legal principles that are essential to the business decision-making process. This coverage of traditional business law topics uses a transactional approach to the students' study of business law. This approach enables the students to be exposed to the most current trends in the law from a traditional perspective.

As in the previous editions, this Fourth Edition continues to present its cases in a briefed form. These decisions are incorporated into the text of each chapter in order to illustrate important legal concepts with real-life examples and to demonstrate the use of legal reasoning to resolve business problems and disputes. These cases were chosen for inclusion based on their ability to represent clearly the current general principles as well as trends in the law.

A new development in this Fourth Edition is the addition of previews and summaries to each chapter. We believe that repetition is one of the keys to the learning process. In the preview, an overview of the chapter is presented. In essence, the preview is an outline of the material contained in the chapter. Next, the text and cases provide an explanation of the legal principles presented in the chapter. Finally, the summary allows students to review quickly the essentials of each chapter. We think these integrated pedagogical tools will enhance students learning and retention of the material. We welcome your comments.

This Fourth Edition is divided into seven parts. This design should enable professors to select the subjects in any order they may wish to cover the material. We believe that this design provides sufficient flexibility for courses on either the quarter or semester system. Furthermore, this edition has material adequate for at least two courses.

Part I serves as an introduction to various sources of the law and to the court system. Chapters 3 and 4 discuss the litigation process in detail. Chapter 5 is a new chapter. It emphasizes alternatives to litigation as methods of resolving controversies. Of particular importance in this chapter is the material on arbitration and administrative agencies. Chapter 6, on torts, places special em-

phasis on the various tort theories used to impose tort liability, especially on the business community. Problems related to malpractice by professional persons such as accountants are highlighted. Chapter 7 is a separate chapter on criminal law because of the increasing importance of white-collar crime and the problems business managers face as a result of the high crime rate. The first seven chapters may be omitted or quickly reviewed if students have had an introductory legal studies course which covered these topics.

Part II, on contracts, is designed to give students 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. This Code is attached as an appendix, and appropriate sections are referred to in brackets within the text. After the introductory chapter, the next four chapters (9 through 12) discuss the essential requirements for every valid contract. Contracts that are contrary to public policy are discussed in Chapter 12. Chapter 13 involves issues of form and interpretation of contract. Chapter 14 includes a discussion of contractual performance, breach, and discharge. Finally, issues created when third parties become involved in contracts are discussed in Chapter 15.

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. Recognizing the major importance of products liability to all businesses, Chapter 19 is dedicated to this topic. The discussion of commercial paper has been substantially reorganized and expanded from four to five chapters. Special emphasis continues to be placed on the liability of parties, including banks, in commercial paper transactions. As with commercial paper, the three chapters on secured transactions have been reorganized and rewritten.

Part IV, on property, also has been reorganized, rewritten, and expanded. After an introductory chapter, methods of acquiring title to both real and personal property are discussed in Chapter 28. Next, transactions involving the sale of real estate are presented. Then, in Chapter 30, the lease of real estate and the bailment of personal property are discussed. Finally, a new chapter on the use of wills and trusts in estate planning is included.

Part V contains four chapters that deal with the law as it relates to creditors and debtors. Chapter 32 covers the use of real estate as security for debts. Chapter 33, on other laws assisting creditors, emphasizes the complex area of suretyship. Chapter 34 gathers in one place much of the recent legislation aimed at protecting debtors and consumers. Chapter 35 includes an examination of the impact of the Bankruptcy Amendments and Federal Judgeship Act of 1984.

Part VI, "Agency," covers the subject in four chapters. Chapter 36 deals with the creation and general principles of the agency relationship. The next two deal with agency and the law of contracts and the law of torts. Chapter 38, on agency and torts, also includes a discussion of the law of employment. A new chapter (39) has been added on the termination of agencies. This chapter includes discussions of the declining importance of the "at-will" doctrine and the growth of employment antidiscrimination protections.

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 organizations, (2) the legal aspects of operating the various forms of organizations, and (3) the law as it relates to dissolution of business organizations.

In addition to the substantial changes made in the text, this Fourth Edition also reflects a substantial change in the authorship of *Fundamentals of Business Law*. Professor William J. Robert has retired from the faculty of the University of Oregon. With gratitude for his years of service, we wish Professor Robert well in his retirement. It is with great pleasure that we welcome Professor Peter J. Shedd as a coauthor. Professor Shedd has taught at the University of Georgia for the past seven years. Professor Shedd has been recognized for his abilities in teaching and research. In 1980, he became the first young faculty member to receive the American Business Law Association's Faculty Award of Excellence. We welcome him and his contributions to this Fourth Edition.

Professor 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. Professor Andrew Emerson of East Texas State University prepared the instructor's manual, and Professor Clark Wheeler of Santa Fe Community College in Gainesville, Florida prepared the test bank. We thank them for their hard work and valuable expertise.

We also would like to acknowledge the valuable assistance of Professor Robert L. Black of the University of Illinois for his extensive review and many helpful suggestions. In addition, we thank the following reviewers: Professor Jane Kelley, Richland College; Dr. Robert D. Haase, University of Wisconsin-Madison, and Donna M. Russo, the Sawyer School. We also thank David Boelio, Executive Editor of Business and Economics at Prentice-Hall. His support during the preparation and production of the manuscript was invaluable. Finally, and most important, we thank Sue Hoy of Athens, Georgia. Her typing of the manuscript made this entire project much more efficient than it would have been otherwise.

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1 Law

CHAPTER PREVIEW

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1. Introduction

Before beginning the study of business law, one should have an understanding of our legal system—where our laws come from, how they are applied, and how they may be changed. The early chapters of this text will discuss the legal system, and the later chapters will consider the law as it relates to business.

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. The basic approach to solving problems of air and water pollution is found in the law. To provide equal employment opportunity, the law now has a significant impact on all hiring, promoting, and firing. In the field of consumer protection, laws regulate the debtor-creditor relationship and other matters of consumer interest. The law thus serves as a scheme of social control of the business community.

2. Definitions

Our view of the law will be a broad one, and our first consideration will be the question: What is law? In everyday conversation, people use the word *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 definition.

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 al-

most every instance. In order to save the reader from tiresome repetition of the phrase "he or she," we use the common gender *he.*

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. 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 Decla-

ration 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.

4. Classifications

Legal subjects may be classified in a variety of ways. As was noted in the preceding sections, laws and legal principles are sometimes classified as substantive or procedural. The law that is used to decide disputes is *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 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 concerned with relationships between individuals.

Public law may be further 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. Chapter 6 discusses the law of torts.

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. Several chapters of this text are devoted to the law of property.

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

5. *Introduction*

Our law comes from four basic sources: (1) constitutions, (2) legislation, (3) judicial decisions, and (4) the rules, regulations, and decisions of administrative agencies. Assuming that administrative agencies are part of the executive branch of government, our law comes from all three branches.

A unique characteristic of American law is that a very substantial part of it is found 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, which relies 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.

As you read further, remember that the judicial system has established a general priority among the various sources of law. Constitutions prevail over statutes, and statutes prevail over common law principles established in court decisions. Courts will not turn to case decisions for law if a statute is directly in point.

6. *Basic Constitutional Principles*

In our constitutional system, the Constitution of the United States and the constitutions of the various states provide the basis of our legal system and our supreme law. All other laws must be consistent with them or they are void. Most state constitutions are modeled after the federal Constitution. They divide state government into executive, legislative, and judicial branches, giving each branch checks and balances on the others. Constitutions also define the powers and functions of the various branches.

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 on 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.

Executive: may veto legislation and appoint judges. (In some states, the judiciary is elected.)

Judiciary: reviews actions of the executive and has power to review laws, to determine whether or not they are constitutional.

The doctrine of judicial review is the heart of the concept of separation of powers. This doctrine and the doctrine of supremacy of the Constitution were established at an early date in our country's history in the celebrated case of *Marbury* v. *Madison.*[1] In this case, Chief Justice Marshall literally created for the court a power that the founding fathers had refused to include in the Constitution. This was the power of the judiciary to review the actions of the other branches of government and to set them aside as null and void if in violation of the Constitution. In creating this power to declare laws unconstitutional, Chief Justice Marshall stated:

> Certainly, all those who have framed written constitutions contemplated them as forming the fundamental and paramount law of the nation, and consequently, the theory of every such government must be that an act of the legislature, repugnant to the constitution, is void. This theory is essentially attached to a written constitution and is, consequently, to be considered by this court as one of the fundamental principles of our society.

Justice Marshall then decided that courts have the power to review the action of the legislative and executive branches of government to determine if they are constitutional. This doctrine of judicial review has, to some extent, made the courts the overseers of government and of all aspects of our daily lives.

7. *Legislation*

Much of our law is legislation. Legislative bodies exist at all levels of government. Legislation is created not only by Congress, but also by state assemblies, city councils, and other local government bodies. The term *legislation* in its broad sense also includes treaties entered into by the executive branch of government and ratified by the Senate.

Legislation enacted by Congress or a state legislature is usually referrred to as a *statute.* Laws passed by local governments are frequently called *ordinances.* Compilations of legislation at all levels of government are called *codes.* For example, we have local traffic codes covering all aspects of driving automobiles and state laws such as the Uniform Commercial Code, which covers all aspects of commercial transactions. The statutes of the United States regulating conduct are known as the U.S. Code.

Legislation at all levels contains general rules for human conduct. Legislation is the result of the political process expressing the public will on an issue. Courts also play a significant role in the field of statutory law. In addition to their power of judicial review, courts interpret legislation and apply it to specific facts. Courts interpret legislation by resolving ambiguities and filling the gaps in the statutes. By its very nature, most legislation is general, and interpretation is necessary to find the intent of the legislature when the statute was enacted.

Legislative bodies have procedural rules that must be followed if a law is to be valid. Among the typical procedural rules are those relating to the way amendments are added to a proposed law, the way proposed statutes are presented for consideration (reading aloud to the members, etc.), and the manner of voting by the members of the legislative body.

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[1] 1 U.S. (Cranch)137 (1803).