

ESSENTIALS OF

# BUSINESS LAW

*And the Legal Environment*

TWELFTH EDITION



Mann & Roberts

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## *And the Legal Environment*

TWELFTH EDITION

**Richard A. Mann**

*The University of North Carolina at Chapel Hill*

*Member of the North Carolina Bar*

**Barry S. Roberts**

*The University of North Carolina at Chapel Hill*

*Member of the North Carolina and Pennsylvania Bars*



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**Richard A. Mann and Barry S. Roberts**

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## *About the Authors*

**RICHARD A. MANN** received a B.S. in mathematics from the University of North Carolina at Chapel Hill and a J.D. from Yale Law School. He is professor emeritus of Business Law at the Kenan-Flagler School of Business, University of North Carolina at Chapel Hill, and is past president of the Southeastern Regional Business Law Association. He is a member of Who's Who in America, Who's Who in American Law, and the North Carolina Bar (inactive).

Professor Mann has written extensively on a number of legal topics, including bankruptcy, sales, secured transactions, real property, insurance law, and business associations. He has received the *American Business Law Journal's* award both for the best article and for the best comment and, in addition, has served as a reviewer and staff editor for the publication. Professor Mann is a coauthor of *Smith and Roberson's Business Law* (sixteenth edition), as well as *Business Law and the Regulation of Business* (eleventh edition) and *Contemporary Business Law*.

**BARRY S. ROBERTS** received a B.S. in business administration from Pennsylvania State University, a J.D. from the University of Pennsylvania, and an LL.M. from Harvard Law School. He served as a judicial clerk for the Pennsylvania Supreme Court prior to practicing law in Pittsburgh. Barry Roberts is professor of business law at the Kenan-Flagler School of Business, University of North Carolina at Chapel Hill, and is a member of Who's Who in American Law and the North Carolina and Pennsylvania Bars (inactive).

Professor Roberts has written numerous articles on such topics as antitrust, products liability, constitutional law, banking law, employment law, and business associations. He has been a reviewer and staff editor for the *American Business Law Journal*. He is a coauthor of *Smith and Roberson's Business Law* (sixteenth edition), as well as *Business Law and the Regulation of Business* (eleventh edition) and *Contemporary Business Law*.

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# Preface

## THE TRADITION CONTINUES

The twelfth edition of *Essentials of Business Law and the Legal Environment* continues the tradition of accuracy, comprehensiveness, and authoritativeness associated with its earlier editions. This text covers its subject material in a succinct, nontechnical but authoritative manner, and provides depth sufficient to ensure easy comprehension by today's students.

### Certified Public Accountant Preparation

This text is designed for use in business law and legal environment of business courses generally offered in universities, colleges, and schools of business and management. Because of its broad and deep coverage, this text may be readily adapted to specially designed courses in business law or the legal environment of business by assigning and emphasizing different combinations of chapters.

Furthermore, this text covers the following parts of the CPA Exam: (1) the legal responsibilities and liabilities of accountants section and (2) the corporate governance portion of the business environment and concepts section. See the inside back cover of this text for a listing of the CPA exam topics covered in this text as well as the chapters covering each topic.

### Uniform CPA Examination Content Specifications

The American Institute of CPAs (AICPA) Board of Examiners has approved and adopted content specification outlines (CSOs) for the four sections of the new computer-based Uniform CPA Examination: Auditing and Attestation, Financial Accounting and Reporting, Regulation, and Business Environment and Concepts. As updated, effective January 1, 2015, the CSOs include the following topics, which are covered in this textbook:

#### Regulation Section

- I. Ethics, Professional, and Legal Responsibilities
  - A. Legal Duties and Responsibilities [of Accountants]
    - 1. Common law duties and liability to clients and third parties
    - 2. Federal statutory liability
    - 3. Privileged communications, confidentiality, and privacy acts
- II. Business Law
  - A. Agency
    - 1. Formation and termination
    - 2. Authority of agents and principals
    - 3. Duties and liabilities of agents and principals
  - B. Contracts
    - 1. Formation
    - 2. Performance
    - 3. Third-party assignments
    - 4. Discharge, breach, and remedies

- C. Uniform Commercial Code
  1. Sales contracts
  2. Negotiable instruments
  3. Secured transactions
  4. Documents of title and title transfer
- D. Debtor–Creditor Relationships
  1. Rights, duties, and liabilities of debtors, creditors, and guarantors
  2. Bankruptcy and insolvency
- E. Government Regulation of Business
  1. Federal securities regulation
  2. Other federal laws and regulations (antitrust, copyright, patents, labor, and employment)
- F. Business Structure (Selection of a Business Entity)
  1. Advantages, disadvantages, implications, and constraints
  2. Formation, operation, and termination
  3. Financial structure, capitalization, profit and loss allocation, and distributions
  4. Rights, duties, legal obligations, and authority of owners and management

### Business Environment and Concepts Section

- I. Corporate Governance
  - A. Rights, Duties, Responsibilities, Authority, and Ethics of the Board of Directors, Officers, and Other Employees

For more information, visit [www.cpa-exam.org](http://www.cpa-exam.org).

### Business Ethics Emphasis

The Chapter 2 Business Ethics case studies require students to make the value trade-offs that confront business people in their professional lives. (We gratefully acknowledge the assistance of James Leis in writing the Mykon’s Dilemma case.) Two-thirds of the chapters also contain an Ethical Dilemma, which presents a managerial situation involving ethical issues. A series of questions leads the student to explore the ethical dimensions of each situation. We wish to acknowledge and thank the following professors for their contributions in preparing the Ethical Dilemmas: Sandra K. Miller, professor of accounting and taxation, Widener University, and Gregory P. Cermignano, associate professor of accounting and business law, Widener University. In addition, to provide further application of ethics in different business contexts, an ethics question follows many cases. These questions are designed to encourage students to consider the ethical dimensions of the facts in the case or of the legal issue invoked by the facts.

## NEW TO THIS EDITION

- **Going Global.** A Going Global feature has been added to fifteen chapters (Chapters 1, 3, 6, 9, 15, 19, 20, 27, 30, 34, 38, 39, 40, 41, and 42), thus integrating international business law content throughout the text. This feature enables students to consider the international aspects of legal issues as they are covered. The International Business Law chapter (Chapter 46) has been retained in its entirety.
- **Updated and Expanded Coverage.** The 2012 amendments to Uniform Commercial Code (UCC) Article 4A has been added to Chapter 27. Coverage of limited liability companies has been updated and expanded in Chapter 32. The Secured Transactions chapter (Chapter 37) covers the most significant provisions of the 2010 amendments to UCC Article 9 and the coverage of suretyship has been updated and expanded. The Employment Law chapter (Chapter 41) covers the Genetic Information Nondiscrimination Act. The chapter on Securities Regulation (Chapter 39) covers the Jumpstart Our Business Startups Act of 2012, the Stop Trading on Congressional Knowledge Act of 2012, and the U.S. Securities and Exchange Commission’s new disclosure rules clarifying how companies can use social media to disseminate information. The Intellectual Property chapter (Chapter 40) includes the changes made by the Foreign

and Economic Espionage Penalty Enhancement Act of 2012. The Environmental Law chapter (Chapter 45) includes coverage of the EPA's regulation of greenhouse gases. The International Business Law chapter (Chapter 46) covers the United Nations Convention on the Law of the Sea (UNCLOS).

- **New Cases.** More than thirty recent legal cases are new to this edition (see Table of Cases). The new cases include recent U.S. Supreme Court decisions such as *Mims v. Arrow Financial Services, LLC*; *Nitro-Lift Technologies, LLC v. Howard*; *Brown v. Entertainment Merchants Association*; *Mayo Foundation for Medical Education and Research v. United States*; *Sackett v. Environmental Protection Agency*; *Radlax Gateway Hotel, LLC v. Amalgamated Bank*; *Association for Molecular Pathology v. Myriad Genetics, Inc.*; *Matrixx Initiatives, Inc. v. Siracusano*; *Vance v. Ball State University*; *Freeman v. Quicken Loans, Inc.*; and *Environmental Protection Agency v. EME Homer City Generation, LP*.
- **Coverage of Recent U.S. Supreme Court Decisions.** The Constitutional Law chapter (Chapter 4) discusses recent U.S. Supreme Court's decisions in the cases challenging the constitutionality of (1) the Patient Protection and Affordable Care Act, (2) the Defense of Marriage Act, (3) a federal statute restricting how much money an individual donor may contribute in total to all candidates or committees during a political cycle, and (4) Michigan's constitutional amendment banning affirmative action in admissions to the state's public universities.
- **Coverage of Restatement of Restitution.** Chapters 9, 11, 13, 14, 15, 17, 18, and 50 cover the new Restatement (Third) of Restitution and Unjust Enrichment.

## KEY FEATURES

### Summarized Cases

The facts, decisions, and opinions for all of the cases are summarized for clarity. Each case is followed by an interpretation, which explains the significance of the case and how it relates to the textual material. We have retained the landmark cases from the prior edition. In addition, we have incorporated more than thirty recent cases, including a number of U.S. Supreme Court cases.

### Case Critical Thinking Questions

Each case is also followed by a critical thinking question to encourage students to examine the legal policy or reasoning behind the legal principle of the case or to apply it in a real-world context.

### Ample Illustrations

We have incorporated more than 220 classroom-tested figures, tables, diagrams, concept reviews, and chapter summaries. The figures, tables, and diagrams help the students conceptualize the many abstract concepts in the law. The Concept Reviews not only summarize prior discussions but also indicate relationships between different legal rules. Moreover, each chapter ends with a summary in the form of an annotated outline of the entire chapter, including key terms.

### Applying the Law

A number of chapters include a feature that provides a systematic legal analysis of a single concept learned in that chapter. It consists of (1) the facts of a hypothetical case, (2) an identification of the broad legal issue presented by those facts, (3) a statement of the applicable rule, (4) the application of the rule to the facts, and (5) a legal conclusion in the case. We wish to acknowledge and thank Professor Ann Olazábal, University of Miami, for her contribution in preparing this feature.

### Business Law in Action

A number of chapters include a scenario that illustrates the application of legal concepts in the chapter to business situations that commonly arise. We wish to acknowledge and thank Professor Ann Olazábal, University of Miami, for her contribution in preparing this feature.

## Practical Advice

Each chapter contains a number of statements that illustrate how legal concepts covered in that chapter can be applied to common business situations.

## Chapter Outcomes

Each chapter begins with a list of learning objectives for the student.

## Enhanced Readability

To improve readability throughout the text, all unnecessary “legalese” has been eliminated, while necessary legal terms have been printed in boldface and clearly defined, explained, and illustrated. Definitions of essential legal terms and legal concepts also appear in the margins. Each chapter is carefully organized with sufficient levels of subordination to enhance the accessibility of the material. The text is enriched by numerous illustrative hypothetical and case examples that help students relate material to real-life experiences.

## Classroom-Proven End-of-Chapter Materials

Classroom-proven questions and case problems appear at the end of the chapters to test the students’ understanding of major concepts. We have used the questions (based on hypothetical situations) and the case problems (taken from reported court decisions) in our own classrooms and consider them excellent stimulants to classroom discussion. Students, in turn, have found the questions and case problems helpful in enabling them to apply the basic rules of law to factual situations.

## Taking Sides

Each chapter—except for Chapters 1 and 2—has an end-of-chapter feature that requires students to apply critical thinking skills to a case-based fact situation. The students are asked to identify the relevant legal rules and develop arguments for both parties to the dispute. In addition, the students are asked to explain how they think a court would resolve the dispute.

## Pedagogical Benefits

Classroom use and study of this book should provide for the student the following benefits and skills:

1. Perception and appreciation of the scope, extent, and importance of the law.
2. Basic knowledge of the fundamental concepts, principles, and rules of law that apply to business transactions.
3. Knowledge of the function and operation of courts and government administrative agencies.
4. Ability to recognize the potential legal problems that may arise in a doubtful or complicated situation, and the necessity of consulting a lawyer and obtaining competent professional legal advice.
5. Development of analytical skills and reasoning power.

# COMPREHENSIVE LEARNING RESOURCES

## Instructor’s Resources

Access instructor resources by going to [login.cengage.com](http://login.cengage.com), logging in with your faculty account username and password, and searching ISBN 9781305075436 to add instructor resources to your account “Bookshelf.”

- The **Instructor’s Manual** prepared by Richard A. Mann, Barry S. Roberts, and Beth D. Woods contains chapter outlines; teaching notes; answers to the Questions, Case Problems, and Taking Sides; and part openers that provide suggested research and outside activities for students.
- **PowerPoint® Slides** clarify course content and guide student note-taking during lectures.



- The **Test Bank** contains thousands of true/false, multiple-choice, and essay questions. The questions vary in levels of difficulty and meet a full range of tagging requirements so that instructors can tailor their testing to meet their specific needs.
- **Cengage Learning Testing Powered by Cognero** is a flexible, online system that allows you to
  - author, edit, and manage test bank content from multiple Cengage Learning solutions
  - create multiple test versions in an instant
  - deliver tests from your Learning Management Systems (LMS), your classroom, or wherever you want

## ADDITIONAL COURSE TOOLS

### MindTap

New for *Essentials of Business Law and the Legal Environment* (twelfth edition) MindTap is a fully online, highly personalized learning environment built on Cengage Learning content. MindTap combines student-learning tools—readings, multimedia, activities, and assessments—into a singular Learning Path that guides students through their course. Instructors can personalize the experience by customizing authoritative Cengage Learning content and learning tools. MindTap offers instructors the ability to add their own content in the Learning Path with apps that integrate into the MindTap framework seamlessly with LMS.

### Business Law Digital Video Library

Featuring more than ninety video clips that spark class discussion and clarify core legal principles, the Business Law Digital Video Library is organized into five series: Legal Conflicts in Business (includes specific modern business and e-commerce scenarios); Ask the Instructor (presents straightforward explanations of concepts for student review); Drama of the Law (features classic business scenarios that spark classroom participation); Real-World Legal (presents legal scenarios encountered in real businesses); and Business Ethics in Action (presents ethical dilemmas in business scenarios). For more information about the Digital Video Library, visit [www.cengage.com/blaw/dvl](http://www.cengage.com/blaw/dvl).

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*Richard A. Mann*

*Barry S. Roberts*

PART I

# INTRODUCTION TO LAW AND ETHICS

CHAPTER 1

*Introduction to Law 2*

CHAPTER 2

*Business Ethics 13*

# Introduction to Law



## CHAPTER 1

*The life of the law has not been logic;  
it has been experience.*

Oliver Wendell Holmes  
*The Common Law* (1881)

### CHAPTER OUTCOMES

After reading and studying this chapter, you should be able to:

1. Identify and describe the basic functions of law.
2. Distinguish between (a) law and justice and (b) law and morals.
3. Distinguish between (a) substantive and procedural law, (b) public and private law, and (c) civil and criminal law.
4. Identify and describe the sources of law.
5. Explain the principle of *stare decisis*.

**L**aw concerns the relations between individuals as such relations affect the social and economic order. It is both the product of civilization and the means by which civilization is maintained. As such, law reflects the social, economic, political, religious, and moral philosophy of society.

Law is an instrument of social control. Its function is to regulate, within certain limitations, human conduct and human relations. Accordingly, the laws of the United States affect the life of every U.S. citizen. At the same time, the laws of each state influence the life of each of its citizens and the lives of many noncitizens as well. The rights and duties of all individuals, as well as the safety and security of all people and their property, depend on the law.

The law is pervasive. It permits, forbids, or regulates practically every human activity and affects all persons either directly or indirectly. Law is, in part, prohibitory: certain acts must not be committed. For example, one must not steal; one must not murder. Law is also partly mandatory: certain acts must be done or be done in a prescribed way. Thus, taxes must be paid; corporations must make and file certain reports with state or federal authorities; traffic must keep to the right. Finally, law is permissive: certain acts may be done. For instance, one may or may not enter into a contract; one may or may not dispose of one's estate by will.

Because the areas of law are so highly interrelated, you will find it helpful to begin the study of the different areas of business law by first considering the nature, classification, and sources of law. This will enable you not only to understand better each specific area of law but also to understand its relationship to other areas of law.

### NATURE OF LAW [1-1]

The law has evolved slowly, and it will continue to change. It is not a pure science based on unchanging and universal truths. Rather, it results from a continuous striving to develop a workable set of rules that balance the individual and group rights of a society.

**Definition of law**

“a rule of civil conduct prescribed by the supreme power in a state, commanding what is right, and prohibiting what is wrong” (William Blackstone)

**Functions of law**

to maintain stability in the social, political, and economic system through dispute resolution, protection of property, and the preservation of the state, while simultaneously permitting ordered change

**Laws and morals**

are different but overlapping: law provides sanctions while morals do not

**Definition of Law [1-1a]**

Scholars and citizens in general often ask a fundamental but difficult question regarding law: what is it? Numerous philosophers and jurists (legal scholars) have attempted to define it. American jurists and Supreme Court Justices Oliver Wendell Holmes and Benjamin Cardozo defined law as predictions of the way in which a court will decide specific legal questions. The English jurist William Blackstone, on the other hand, defined law as “a rule of civil conduct prescribed by the supreme power in a state, commanding what is right, and prohibiting what is wrong.”

Because of its great complexity, many legal scholars have attempted to explain the law by outlining its essential characteristics. Roscoe Pound, a distinguished American jurist and former dean of the Harvard Law School, described law as having multiple meanings:

First we may mean the legal order, that is, the régime of ordering human activities and relations through systematic application of the force of politically organized society, or through social pressure in such a society backed by such force. We use the term “law” in this sense when we speak of “respect for law” or for the “end of law.”

Second we may mean the aggregate of laws or legal precepts; the body of authoritative grounds of judicial and administrative action established in such a society. We may mean the body of received and established materials on which judicial and administrative determinations proceed. We use the term in this sense when we speak of “systems of law” or of “justice according to law.”

Third we may mean what Justice Cardozo has happily styled “the judicial process.” We may mean the process of determining controversies, whether as it actually takes place, or as the public, the jurists, and the practitioners in the courts hold it ought to take place.

**Functions of Law [1-1b]**

At a general level the primary **function of law** is to maintain stability in the social, political, and economic system while simultaneously permitting change. The law accomplishes this basic function by performing a number of specific functions, among them dispute resolution, protection of property, and preservation of the state.

Disputes, which arise inevitably in any modern society, may involve criminal matters, such as theft, or noncriminal matters, such as an automobile accident. Because disputes threaten social stability, the law has established an elaborate and evolving set of rules to resolve them. In addition, the legal system has instituted societal remedies, usually administered by the courts, in place of private remedies such as revenge.

A second crucial function of law is to protect the private ownership of property and to assist in the making of voluntary agreements (called contracts) regarding exchanges of property and services. Accordingly, a significant portion of law, as well as this text, involves property and its disposition, including the law of property, contracts, sales, commercial paper, and business associations.

A third essential function of the law is preservation of the state. In our system, law ensures that changes in political structure and leadership are brought about by political action, such as elections, legislation, and referenda, rather than by revolution, sedition, and rebellion.

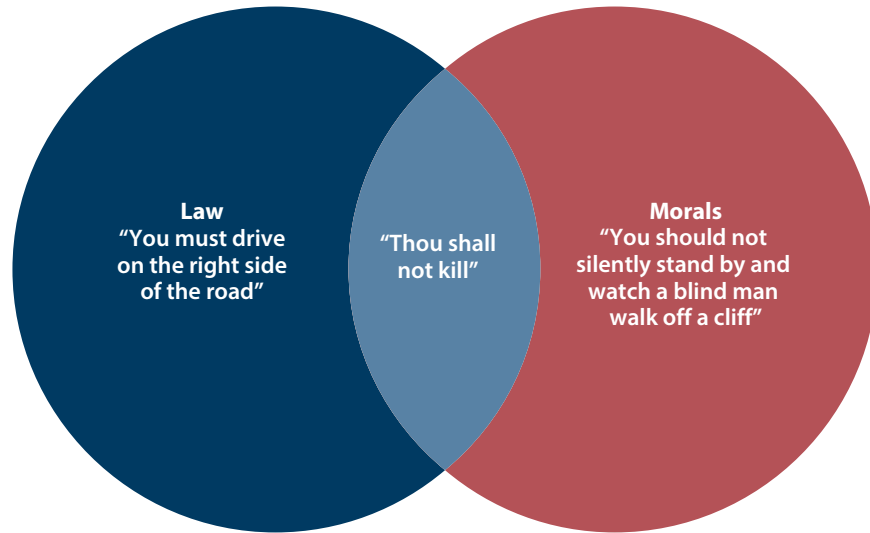
**Law and Morals [1-1c]**

Although moral concepts greatly influence the law, morals and law are not the same. You might think of them as two intersecting circles (see Figure 1-1). The area common to both circles includes the vast body of ideas that are both moral and legal. For instance, “Thou shall not kill” and “Thou shall not steal” are both moral precepts and legal constraints.

On the other hand, the part of the legal circle that does not intersect the morality circle includes many rules of law that are completely unrelated to morals, such as the rules stating that you must drive on the right side of the road and that you must register before you can vote. Likewise, the part of the morality circle that does not intersect the legal circle includes moral precepts not enforced by legal sanctions, such as the idea that you should not silently stand by and watch a blind man walk off a cliff or that you should provide food to a starving child.



Figure 1-1 Law and Morals



### Law and Justice [1-1d]

**Law and justice** are separate and distinct concepts; justice is the fair, equitable, and impartial treatment of competing interests with due regard for the common good

**Law and justice** represent separate and distinct concepts. Without law, however, there can be no justice. Although defining justice is at least as difficult as defining law, justice generally may be defined as the fair, equitable, and impartial treatment of the competing interests and desires of individuals and groups with due regard for the common good.

On the other hand, law is no guarantee of justice. Some of history’s most monstrous acts have been committed pursuant to “law.” Examples include the actions of Nazi Germany during the 1930s and 1940s and the actions of the South African government under apartheid from 1948 until 1994. Totalitarian societies often have shaped formal legal systems around the atrocities they have sanctioned.

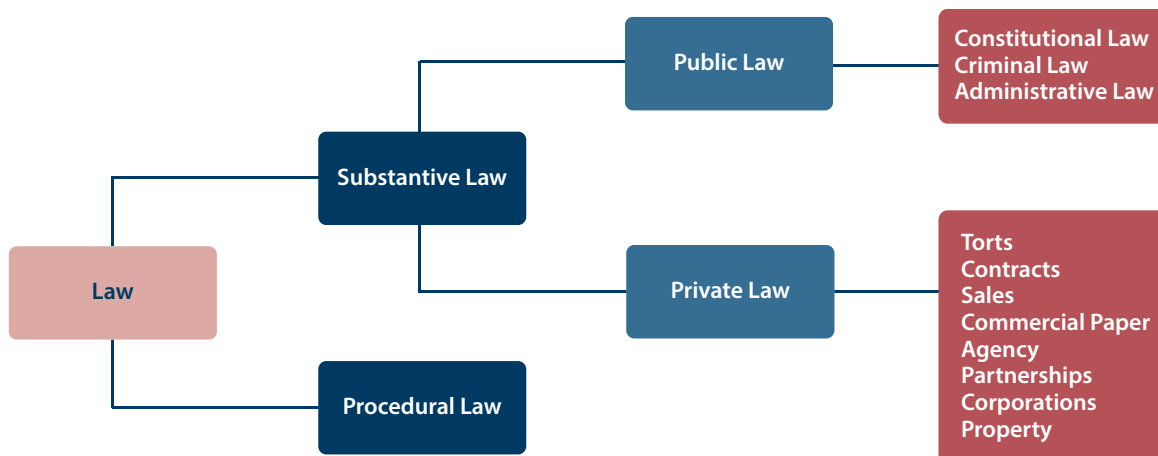
### CLASSIFICATION OF LAW [1-2]

**Right** legal capacity to require another person to perform or refrain from performing an act

Because the subject is vast, classifying the law into categories is helpful. Though a number of categories are possible, the most useful ones are (1) substantive and procedural, (2) public and private, and (3) civil and criminal. See Figure 1-2, which illustrates a classification of law.

Basic to understanding these classifications are the terms *right* and *duty*. A **right** is the capacity of a person, with the aid of the law, to require another person or persons to perform, or to refrain from performing, a certain act. Thus, if Alice sells and delivers goods to Bob for the

Figure 1-2 Classification of Law





- Duty**  
legal obligation requiring a person to perform or refrain from performing an act
- Substantive law**  
the basic law creating rights and duties
- Procedural law**  
rules for enforcing substantive law
- Public law**  
the law dealing with the relationship between government and individuals
- Private law**  
the law involving relationships among individuals and legal entities
- Civil law**  
the law dealing with the rights and duties of individuals among themselves
- Criminal law**  
the law that involves offenses against the entire community
- Sue**  
to begin a lawsuit in a court
- Defendant**  
the person against whom a legal action is brought
- Plaintiff**  
the person who initiates a civil suit
- Prosecute**  
to bring a criminal proceeding

agreed price of \$500 payable at a certain date, Alice is capable, with the aid of the courts, of enforcing the payment by Bob of the \$500. A **duty** is the obligation the law imposes upon a person to perform, or to refrain from performing, a certain act. Duty and right are correlatives: no right can rest upon one person without a corresponding duty resting upon some other person, or in some cases upon all other persons.

### Substantive and Procedural Law [1-2a]

**Substantive law** creates, defines, and regulates legal rights and duties. Thus, the rules of contract law that determine a binding contract are rules of substantive law. On the other hand, **procedural law** sets forth the rules for enforcing those rights that exist by reason of the substantive law. Thus, procedural law defines the method by which to obtain a remedy in court.

### Public and Private Law [1-2b]

**Public law** is the branch of substantive law that deals with the government’s rights and powers and its relationship to individuals or groups. Public law consists of constitutional, administrative, and criminal law. **Private law** is that part of substantive law governing individuals and legal entities (such as corporations) in their relationships with one another. Business law is primarily private law.

### Civil and Criminal Law [1-2c]

The **civil law** defines duties, the violation of which constitutes a wrong against the party injured by the violation. In contrast, the **criminal law** establishes duties, the violation of which is a wrong against the whole community. Civil law is a part of private law, whereas criminal law is a part of public law. (The term *civil law* should be distinguished from the concept of a civil law system, which is discussed later in this chapter.) In a civil action the injured party **sues** to recover *compensation* for the damage and injury sustained as a result of the **defendant’s** wrongful conduct. The party bringing a civil action (the **plaintiff**) has the burden of proof, which the plaintiff must sustain by a *preponderance* (greater weight) *of the evidence*. The purpose of the civil law is to compensate the injured party, not, as in the case of criminal law, to punish the wrongdoer. The principal forms of relief the civil law affords are a judgment for money damages and a decree ordering the defendant to perform a specified act or to desist from specified conduct.

A crime is any act prohibited or omission required by public law in the interest of protecting the public and made punishable by the government in a judicial proceeding brought (**prosecuted**) by it. The government must prove criminal guilt *beyond a reasonable doubt*, which is a significantly higher burden of proof than that required in a civil action. Crimes are prohibited and punished on the grounds of public policy, which may include the safeguarding of government, human life, or private property. Additional purposes of criminal law include deterrence and rehabilitation. See Concept Review 1-1 for a comparison of civil and criminal law.

## CONCEPT REVIEW 1-1

### Comparison of Civil and Criminal Law

	Civil Law	Criminal Law
<b>Commencement of Action</b>	Aggrieved individual (plaintiff) sues	State or federal government prosecutes
<b>Purpose</b>	Compensation Deterrence	Punishment Deterrence Rehabilitation Preservation of peace
<b>Burden of Proof</b>	Preponderance of the evidence	Beyond a reasonable doubt
<b>Principal Sanctions</b>	Monetary damages Equitable remedies	Capital punishment Imprisonment Fines

## SOURCES OF LAW [1-3]

The sources of law in the U.S. legal system are the federal and state constitutions, federal treaties, interstate compacts, federal and state statutes and executive orders, the ordinances of countless local municipal governments, the rules and regulations of federal and state administrative agencies, and an ever-increasing volume of reported federal and state court decisions.

The *supreme law* of the land is the U.S. Constitution, which provides in turn that federal statutes and treaties shall be paramount to state constitutions and statutes. Federal legislation is of great significance as a source of law. Other federal actions having the force of law are executive orders by the President and rules and regulations set by federal administrative officials, agencies, and commissions. The federal courts also contribute considerably to the body of law in the United States.

The same pattern exists in every state. The paramount law of each state is contained in its written constitution. (Although a state constitution cannot deprive citizens of federal constitutional rights, it can guarantee rights beyond those provided in the U.S. Constitution.) State constitutions tend to be more specific than the U.S. Constitution and, generally, have been amended more frequently. Subordinate to the state constitution are the statutes enacted by the state's legislature and the case law developed by its judiciary. Likewise, rules and regulations of state administrative agencies have the force of law, as do executive orders issued by the governors of most states. In addition, cities, towns, and villages have limited legislative powers to pass ordinances and resolutions within their respective municipal areas. See Figure 1-3, which illustrates this hierarchy.

### Constitutional Law [1-3a]

A **constitution**—the fundamental law of a particular level of government—establishes the governmental structure and allocates power among governmental levels, thereby defining political relationships. One of the fundamental principles on which our government is founded is that of separation of powers. As incorporated into the U.S. Constitution, this means that government consists of three distinct and independent branches—the federal judiciary, the Congress, and the executive branch.

A constitution also restricts the powers of government and specifies the rights and liberties of the people. For example, the Constitution of the United States not only specifically states what rights and authority are vested in the national government but also specifically enumerates certain rights and liberties of the people. Moreover, the Ninth Amendment to the U.S. Constitution makes it clear that this enumeration of rights does not in any way deny or limit other rights that the people retain.

All other law in the United States is subordinate to the federal Constitution. No law, federal or state, is valid if it violates the federal Constitution. Under the principle of **judicial review**, the Supreme Court of the United States determines the constitutionality of *all* laws.

### Judicial Law [1-3b]

The U.S. legal system, a **common law system** like the system first developed in England, relies heavily on the judiciary as a source of law and on the adversary system for settling disputes. In an **adversary system** the parties, not the court, must initiate and conduct litigation. This approach is based on the belief that the truth is more likely to emerge from the investigation and presentation of evidence by two opposing parties, both motivated by self-interest, than from judicial investigation motivated only by official duty. In addition to the United States and England, the common law system is used in other English-speaking countries, including Canada and Australia.

In distinct contrast to the common law system are civil law systems, which are based on Roman law. **Civil law systems** depend on comprehensive legislative enactments (called codes) and an inquisitorial system of determining disputes. In the **inquisitorial system**, the judiciary initiates litigation, investigates pertinent facts, and conducts the presentation of evidence. The civil law system prevails in most of Europe, Scotland, the state of Louisiana, the province of Quebec, Latin America, and parts of Africa and Asia.

#### Constitution

fundamental law of a government establishing its powers and limitations

#### Judicial review

authority of the courts to determine the constitutionality of legislative and executive acts

#### Common law system

body of law originating in England and derived from judicial decisions

#### Adversary system

system in which opposing parties initiate and present their cases

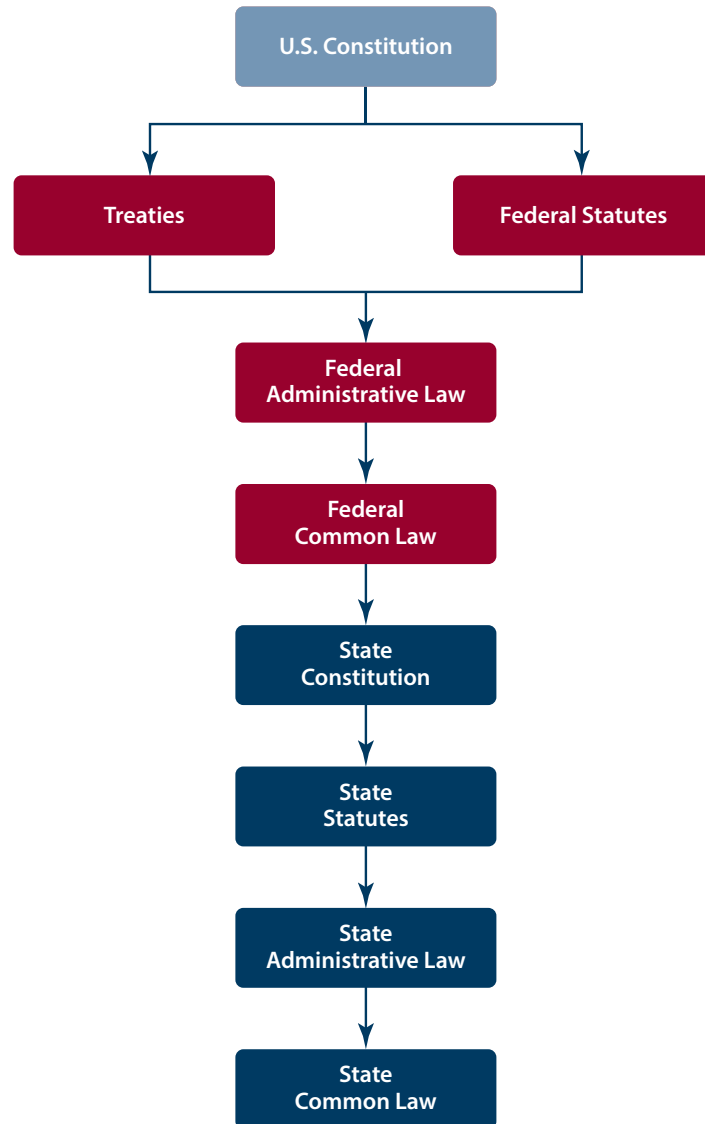
#### Civil law system

body of law derived from Roman law and based upon comprehensive legislative enactments

#### Inquisitorial system

system in which the judiciary initiates, conducts, and decides cases

Figure I-3 Hierarchy of Law



**Common Law** The courts in common law systems have developed a body of law that serves as precedent for determining later controversies. In this sense, common law, also called case law or judge-made law, is distinguished from other sources of law, such as legislation and administrative rulings.

To evolve in a stable and predictable manner, the common law has developed by application of *stare decisis* (“to stand by the decisions”). Under the principle of *stare decisis*, courts adhere to and rely on rules of law that they or superior courts relied on and applied in prior similar decisions. Judicial decisions thus have two uses: (1) to determine with finality the case currently being decided and (2) to indicate how the court will decide similar cases in the future. *Stare decisis* does not, however, preclude courts from correcting erroneous decisions or from choosing among conflicting precedents. Thus, the doctrine allows sufficient flexibility for the common law to change. The strength of the common law is its ability to adapt to change without losing its sense of direction.

**Equity** As the common law developed in England, it became overly rigid and beset with technicalities. As a consequence, in many cases no remedies were provided because the judges insisted that a claim must fall within one of the recognized forms of action. Moreover, courts of common law could provide only limited remedies; the principal type of relief obtainable was a

**Stare decisis**  
principle that courts should apply rules decided in prior cases in deciding substantially similar cases

monetary judgment. Consequently, individuals who could not obtain adequate relief from monetary awards began to petition the king directly for justice. He, in turn, came to delegate these petitions to his chancellor.

Gradually, there evolved what was in effect a new and supplementary system of needed judicial relief for those who could not receive adequate remedies through the common law. This new system, called **equity**, was administered by a court of chancery presided over by the chancellor. The chancellor, deciding cases on “equity and good conscience,” regularly provided relief where common law judges had refused to act or where the remedy at law was inadequate. Thus, there grew up, side by side, two systems of law administered by different tribunals, the common law courts and the courts of equity.

An important difference between common law and equity is that the chancellor could issue a **decree**, or order, compelling a defendant to do, or refrain from doing, a specified act. A defendant who did not comply with this order could be held in contempt of court and punished by fine or imprisonment. This power of compulsion available in a court of equity opened the door to many needed remedies not available in a court of common law.

Courts of equity in some cases recognized rights that were enforceable at common law, but they provided more effective remedies. For example, in a court of equity, for breach of a land contract the buyer could obtain a decree of **specific performance** commanding the defendant seller to perform his part of the contract by transferring title to the land. Another powerful and effective remedy available only in the courts of equity was the **injunction**, a court order requiring a party to do or refrain from doing a specified act. Another remedy not available elsewhere was **reformation**, where, upon the ground of mutual mistake, an action could be brought to reform or change the language of a written agreement to conform to the actual intention of the contracting parties. An action for **rescission** of a contract, which allowed a party to invalidate a contract under certain circumstances, was another remedy.

Although courts of equity provided remedies not available in courts of law, they granted such remedies only at their discretion, not as a matter of right. This discretion was exercised according to the general legal principles, or **maxims**, formulated by equity courts over the years.

In nearly every jurisdiction in the United States, courts of common law and equity have merged into a single court that administers both systems of law. Vestiges of the old division remain, however. For example, the right to a trial by jury applies only to actions at law, but not, under federal law and in almost every state, to suits filed in equity.

See Concept Review 1-2 for a comparison of law and equity.

**Restatements of Law** The common law of the United States results from the independent decisions of the state and federal courts. The rapid increase in the number of decisions by these courts led to the establishment of the American Law Institute (ALI) in 1923. The ALI is composed of a distinguished group of lawyers, judges, and law professors who set out to prepare

### Equity

body of law based upon principles distinct from common law and providing remedies not available at law

### Decree

decision of a court of equity

### Specific performance

decree ordering a party to perform a contractual duty

### Injunction

decree ordering a party to do or refrain from doing a specified act

### Reformation

equitable remedy rewriting a contract to conform with the original intent of the contracting parties

### Rescission

an equitable remedy invalidating a contract

### Maxim

a general legal principle

## CONCEPT REVIEW 1-2

### *Comparison of Law and Equity*

	Law	Equity
<b>Availability</b>	Generally	Discretionary: if remedy at law is inadequate
<b>Precedents</b>	<i>Stare decisis</i>	Equitable maxims
<b>Jury</b>	If either party demands	None in federal and almost all states
<b>Remedies</b>	Judgment for monetary damages	Decree of specific performance, injunction, reformation, rescission

an orderly restatement of the general common law of the United States, including in that term not only the law developed solely by judicial decision, but also the law that has grown from the application by the courts of statutes that were generally enacted and were in force for many years.

Currently the ALI is made up of more than 4,300 lawyers, judges, and law professors.

Regarded as the authoritative statement of the common law of the United States, the Restatements cover many important areas of the common law, including torts, contracts, agency, property, and trusts. Although not law in themselves, they are highly persuasive, and courts frequently have used them to support their opinions. Because they provide a concise and clear statement of much of the common law, relevant portions of the Restatements are relied on frequently in this book.

## Legislative Law [1-3c]

Since the end of the nineteenth century, legislation has become the primary source of new law and ordered social change in the United States. The annual volume of legislative law is enormous. Justice Felix Frankfurter's remarks to the New York City Bar in 1947 are even more appropriate in the twenty-first century:

Inevitably the work of the Supreme Court reflects the great shift in the center of gravity of law-making. Broadly speaking, the number of cases disposed of by opinions has not changed from term to term. But even as late as 1875 more than 40 percent of the controversies before the Court were common-law litigation, fifty years later only 5 percent, while today cases not resting on statutes are reduced almost to zero. It is therefore accurate to say that courts have ceased to be the primary makers of law in the sense in which they "legislated" the common law. It is certainly true of the Supreme Court that almost every case has a statute at its heart or close to it.

This emphasis on legislative or statutory law has occurred because common law, which develops evolutionarily and haphazardly, is not well suited for making drastic or comprehensive changes. Moreover, while courts tend to be hesitant about overruling prior decisions, legislatures commonly repeal prior enactments. In addition, legislatures may choose the issues they wish to address, whereas courts may deal only with those issues presented by actual cases. As a result, legislatures are better equipped to make the dramatic, sweeping, and relatively rapid changes in the law that technological, social, and economic innovations compel.

While some business law topics, such as contracts, agency, property, and trusts, still are governed principally by the common law, most areas of commercial law, including partnerships, corporations, sales, commercial paper, secured transactions, insurance, securities regulation, anti-trust, and bankruptcy have become largely statutory. Because most states enacted their own statutes dealing with these branches of commercial law, a great diversity developed among the states and hampered the conduct of commerce on a national scale. The increased need for greater uniformity led to the development of a number of proposed uniform laws that would reduce the conflicts among state laws.

The most successful example is the *Uniform Commercial Code (UCC)*, which was prepared under the joint sponsorship and direction of the ALI and the Uniform Law Commission (ULC), which is also known as the National Conference of Commissioners on Uniform State Laws (NCCUSL). All fifty states (although Louisiana has adopted only Articles 1, 3, 4, 5, 7, and 8), the District of Columbia, and the Virgin Islands have adopted the UCC.

The ULC has drafted more than three hundred uniform laws, including the Uniform Partnership Act, the Uniform Limited Partnership Act, and the Uniform Probate Code. The ALI has developed a number of model statutory formulations, including the Model Code of Evidence, the Model Penal Code, and a Model Land Development Code. In addition, the American Bar Association has promulgated the Model Business Corporation Act.

### Treaty

an agreement between or among independent nations

**Treaties** A **treaty** is an agreement between or among independent nations. The U.S. Constitution authorizes the President to enter into treaties with the advice and consent of the Senate, "providing two thirds of the Senators present concur."

Treaties may be entered into only by the federal government, not by the states. A treaty signed by the President and approved by the Senate has the legal force of a federal statute. Accordingly, a federal treaty may supersede a prior federal statute, while a federal statute may