



BUSINESS LAW

TEXT AND CASES

Fourteenth Edition

CLARKSON • MILLER • CROSS

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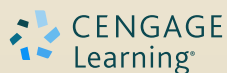
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Preface

The study of business law and the legal environment of business has universal applicability. A student entering any field of business must have at least a passing understanding of business law in order to function in the real world. *Business Law*, Fourteenth Edition, provides the information that students need in an interesting and contemporary way.

Additionally, students preparing for a career in accounting, government and political science, economics, and even medicine can use much of the information they learn in a business law and legal environment course. In fact, every individual throughout his or her lifetime can benefit from knowledge of contracts, real property law, landlord-tenant relationships, and other business law topics. Consequently, we have fashioned this text as a useful “tool for living” for all of your students (including those taking the CPA exam).

For the Fourteenth Edition, we have spent a great deal of effort making this best-selling text more modern, exciting, and visually appealing than ever before. We have added more than forty new features, ninety-two new cases, and twenty-four new exhibits. The text also contains nearly two hundred new highlighted and numbered *Cases in Point* and *Examples*, and more than a hundred new case problems. Special pedagogical elements within the text focus on legal, ethical, global, and corporate issues while addressing core curriculum requirements.

Highlights of the Fourteenth Edition

Instructors have come to rely on the coverage, accuracy, and applicability of *Business Law*. To make sure that our text engages your students, solidifies their understanding of legal concepts, and provides the best teaching tools available, we now offer the following.

A Variety of New and Exciting Features

The Fourteenth Edition of *Business Law* is filled with many new features specifically designed to cover current legal topics of high interest. There are forty-one features in this edition, thirty-eight of which are new.

Each feature is related to a topic discussed in the text and ends with *Critical Thinking* or *Business Questions*. **Suggested answers to all the *Critical Thinking* and *Business Questions* are included in the *Solutions Manual for this text*.**

- 1. *Ethics Today*** These features focus on the ethical aspects of a topic discussed in the text to emphasize that ethics is an integral part of a business law course. Examples include:
 - *Stare Decisis* versus Spiderman (Chapter 1)
 - Forced Arbitration: Right or Wrong? (Chapter 15)
 - When Imported Beer Really Isn't Imported (Chapter 24)
 - Should There Be More Relief for Student Loan Defaults? (Chapter 31)
 - Is It Fair to Classify Uber and Lyft Drivers as Independent Contractors? (Chapter 32)
- 2. *Global Insight*** These features illustrate how other nations deal with specific legal concepts to give students a sense of the global legal environment. Subjects include:
 - Islamic Law and *Respondeat Superior* (Chapter 33)
 - Does Cloud Computing Have a Nationality? (Chapter 39)
 - Anti-Bribery Charges Take Their Toll on U.S. and Foreign Corporations (Chapter 40)
- 3. *NEW Digital Update*** These features are designed to examine cutting-edge cyberlaw topics, such as the following:
 - Using Social Media for Service of Process (Chapter 3)
 - Should Employees Have a “Right of Disconnecting”? (Chapter 5)
 - Revenge Porn and Invasion of Privacy (Chapter 6)
 - Monitoring Employees' Social Media—Right or Wrong? (Chapter 9)
 - Hiring Discrimination Based on Social Media Posts (Chapter 35)
- 4. *Managerial Strategy*** These features emphasize the management aspects of business law and the legal environment. Topics include:
 - Should You Consent to Have Your Business Case Decided by a U.S. Magistrate Judge? (Chapter 2)
 - Marriage Equality and the Constitution (Chapter 4)

- When Is a Warning Legally Bulletproof? (Chapter 7)
- The Criminalization of American Business (Chapter 10)
- Commercial Use of Drones (Chapter 21)
- The SEC's New CEO Pay-Ratio Disclosure Rule (Chapter 42)

Entire Chapter on Internet Law, Social Media, And Privacy

For the Fourteenth Edition, we include a whole chapter (Chapter 9) on *Internet Law, Social Media, and Privacy*. Social media have entered the mainstream and become a part of everyday life for many businesspersons. In this special chapter, we give particular emphasis to the legal issues surrounding the Internet, social media, and privacy. We also recognize this trend throughout the text by incorporating the Internet and social media as they relate to the topics under discussion.

New Coverage of Topics on the Revised 2017 CPA Exam

In 2016, the American Institute of CPAs (AICPA) issued its final report on “Maintaining the Relevance of the Uniform CPA Exam.” In addition to more focus on critical thinking, authentic applications, and problem solving, the content of the exam will change to an extent.

The Fourteenth Edition of *Business Law* incorporates information on the new topics on the CPA exam, specifically addressing the following:

- Agency law (worker classification and duties of principals and agents)
- Employment law (Affordable Care Act)
- Business organizations (corporate governance issues, including Sarbanes-Oxley compliance and criminal liability for organizations and management)

In addition, the Fourteenth Edition continues to cover topics that are essential to new CPAs who are working with sophisticated business clients, regardless of whether the CPA exam covers these topics. We recognize that today's business leaders must often think “outside the box” when making business decisions. For this reason, we strongly emphasize business and critical thinking elements throughout the text. We have carefully chosen cases, features, and problems that are relevant to business operations. Almost all of the features and cases conclude with some type of critical thinking

question. For those teaching future CPAs, this is consistent with the new CPA exam's focus on higher-order skills, such as critical thinking and problem solving.

Highlighted and Numbered *Examples* and *Cases in Point* Illustrations

Many instructors use cases and examples to illustrate how the law applies to business. Students understand legal concepts better in the context of their real-world application. Therefore, for this edition of *Business Law*, we have expanded the number of highlighted numbered *Examples* and *Cases in Point* in every chapter. We have added 137 new *Cases in Point* and 52 new *Examples*.

Examples illustrate how the law applies in a specific situation. *Cases in Point* present the facts and issues of an actual case and then describe the court's decision and rationale. These two features are uniquely designed and consecutively numbered throughout each chapter for easy reference. The *Examples* and *Cases in Point* are integrated throughout the text to help students better understand how courts apply legal principles in the real world.

New Unit-Ending *Application and Ethics* Features

For the Fourteenth Edition, we have created an entirely new feature that concludes each of the ten units in the text. Each of these *Application and Ethics* features provides additional analysis on a topic related to that unit and explores its ethics ramifications. Each of the features ends with two questions—a *Critical Thinking* and an *Ethics Question*. Some topics covered by these features include the following:

- The Biggest Data Breach of All Time (Unit 2)
- Fantasy Sports—Legal Gambling? (Unit 3)
- Virtual Currency—Is It Safe? (Unit 5)
- Health Insurance and Small Business (Unit 7)

Suggested answers to the questions in *Application and Ethics* features are included in the *Solutions Manual* for this text.

New Cases and Case Problems

For the Fourteenth Edition of *Business Law*, we have added 92 new cases and 111 new case problems, most from 2016 and 2015. The new cases and problems have been carefully selected to illustrate important points of law and to be of high interest to students and instructors.

We have made it a point to find recent cases that enhance learning and are relatively easy to understand.

1. **Spotlight Cases and Classic Cases.** Certain cases and case problems that are exceptionally good teaching cases are labeled as *Spotlight Cases* and *Spotlight Case Problems*. Examples include *Spotlight on Amazon*, *Spotlight on Beer Labels*, *Spotlight on Gucci*, *Spotlight on Nike*, and *Spotlight on the Seattle Mariners*. Instructors will find these *Spotlight Cases* useful to illustrate the legal concepts under discussion, and students will enjoy studying the cases because they involve interesting and memorable facts. Other cases have been chosen as *Classic Cases* because they establish a legal precedent in a particular area of law.
2. **Critical Thinking Section.** Each case concludes with a *Critical Thinking* section, which normally includes two questions. The questions may address *Legal Environment*, *E-Commerce*, *Economic*, *Environmental*, *Ethical*, *Global*, *Political*, or *Technological* issues, or they may ask *What If the Facts Were Different?* Each *Classic Case* has a section titled *Impact of This Case on Today's Law* and one *Critical Thinking* question.
3. **Longer Excerpts for Case Analysis.** We have also included one longer case excerpt in every chapter—labeled *Case Analysis*—followed by three *Legal Reasoning Questions*. The questions are designed to guide students' analysis of the case and build their legal reasoning skills. These *Case Analysis* cases may be used for case-briefing assignments and are also tied to the *Special Case Analysis* questions found in every unit of the text (one per unit).

Suggested answers to all case-ending questions and case problems are included in the *Solutions Manual* for this text.

Business Case Problem with Sample Answer in Each Chapter

In response to those instructors who would like students to have sample answers available for some of the questions and case problems, we include a *Business Case Problem with Sample Answer* in each chapter. The *Business Case Problem with Sample Answer* is based on an actual case, and students can find a sample answer at the end of the text. **Suggested answers to the *Business Case Problems with Sample Answers* are provided in Appendix E at the end of the text and in the *Solutions Manual* for this text.**

New Exhibits and Concept Summaries

For this edition, we have spent considerable effort reworking and redesigning all of the exhibits and concept summaries in the text to achieve better clarity and more visual appeal. In addition, we have added twenty-four new exhibits and four new concept summaries.

Special Case Analysis Questions

For one chapter in every unit of the text, we provide a *Special Case Analysis* question that is based on the *Case Analysis* excerpt in that chapter. These special questions appear in the *Business Case Problems* at the ends of selected chapters.

The *Special Case Analysis* questions are designed to build students' analytical skills. They test students' ability to perform IRAC (Issue, Rule, Application, and Conclusion) case analysis. Students must identify the legal issue presented in the chapter's *Case Analysis Case*, understand the rule of law, determine how the rule applies to the facts of the case, and describe the court's conclusion. Instructors can assign these questions as homework or use them in class to elicit student participation and teach case analysis. **Suggested answers to the *Special Case Analysis* questions can be found in the *Solutions Manual* for this text.**

Reviewing Features in Every Chapter

In the Fourteenth Edition of *Business Law*, we continue to offer a *Reviewing* feature at the end of every chapter to help solidify students' understanding of the chapter materials. Each *Reviewing* feature presents a hypothetical scenario and then asks a series of questions that require students to identify the issues and apply the legal concepts discussed in the chapter.

These features are designed to help students review the chapter topics in a simple and interesting way and see how the legal principles discussed in the chapter affect the world in which they live. An instructor can use these features as the basis for in-class discussion or encourage students to use them for self-study prior to completing homework assignments. **Suggested answers to the questions posed in the *Reviewing* features can be found in the *Solutions Manual* for this text.**

Two Issue Spotters

At the conclusion of each chapter, we have included a special section with two *Issue Spotters* related to the chapter's topics. These questions facilitate student learning

and review of the chapter materials. **Suggested answers to the *Issue Spotters* in every chapter are provided in Appendix D at the end of the text and in the *Solutions Manual* for this text.**

Legal Reasoning Group Activities

For instructors who want their students to engage in group projects, each chapter of the Fourteenth Edition includes a special *Legal Reasoning Group Activity*. Each activity begins by describing a business scenario and then poses several specific questions pertaining to the scenario. Each question is to be answered by a different group of students based on the information in the chapter. These projects may be used in class to spur discussion or as homework assignments. **Suggested answers to the *Legal Reasoning Group Activities* are included in the *Solutions Manual* for this text.**

Supplements/Digital Learning Systems

Business Law, Fourteenth Edition, provides a comprehensive supplements package designed to make the tasks of teaching and learning more enjoyable and efficient. The following supplements and exciting new digital products are offered in conjunction with the text.

MindTap

MindTap for *Business Law*, Fourteenth Edition, is a fully online, highly personalized learning experience built upon Cengage Learning content. MindTap combines student learning tools—such as readings, multimedia, activities, and assessments from CengageNOW—into a singular Learning Path that intuitively 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 Learning Management Systems (LMS).

MindTap includes:

- **An Interactive book with Whiteboard Videos and Interactive Cases.**
- **Automatically graded homework** with the following consistent question types:

- **Worksheets**—Interactive Worksheets prepare students for class by ensuring reading and comprehension.
- **Video Activities**—Real-world video exercises make business law engaging and relevant.
- **Brief Hypotheticals**—These applications provide students practice in spotting the issue and applying the law in the context of a short, factual scenario.
- **Case Problem Analyses**—These promote deeper critical thinking and legal reasoning by guiding students step-by-step through a case problem and then adding in a critical thinking section based on “What If the Facts Were Different?” These now include a third section, a writing component, which requires students to demonstrate their ability to forecast the legal implications of real-world business scenarios.
- **Personalized Student Plan with multimedia study tools and videos.**
- **New Adaptive Test Prep** helps students study for exams.
- **Test Bank.**
- **Reporting and Assessment options.**

By using the MindTap system, students can complete the assignments online and can receive instant feedback on their answers. Instructors can utilize MindTap to upload their course syllabi, create and customize homework assignments, and keep track of their students’ progress. By hiding, rearranging, or adding content, instructors control what students see and when they see it to match the Learning Path to their course syllabus exactly. Instructors can also communicate with their students about assignments and due dates, and create reports summarizing the data for an individual student or for the whole class.

Cengage Learning Testing Powered by Cognero

Cengage Learning Testing Powered by Cognero is a flexible, online system that allows you to do the following:

- Author, edit, and manage *Test Bank* content from multiple Cengage Learning solutions.
- Create multiple test versions in an instant.
- Deliver tests from your LMS, your classroom, or wherever you want.

Start Right Away! *Cengage Learning Testing Powered by Cognero* works on any operating system or browser.

- No special installs or downloads are needed.
- Create tests from school, home, the coffee shop—anywhere with Internet access.

What Will You Find?

- *Simplicity at every step.* A desktop-inspired interface features drop-down menus and familiar intuitive tools that take you through content creation and management with ease.
- *Full-featured test generator.* Create ideal assessments with your choice of fifteen question types—including true/false, multiple choice, opinion scale/Likert, and essay). Multi-language support, an equation editor, and unlimited meta-data help ensure your tests are complete and compliant.
- *Cross-compatible capability.* Import and export content to and from other systems.

Instructor's Companion Web Site

The Web site for the Fourteenth Edition of *Business Law* can be found by going to www.cengagebrain.com and entering ISBN 9781305967250. The Instructor's Companion Web Site contains the following supplements:

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For Users of the Thirteenth Edition

First of all, we want to thank you for helping make *Business Law* the best-selling business law text in America today. Second, we want to make you aware of the numerous additions and changes that we have made in this edition—many in response to comments from reviewers.

Every chapter of the Fourteenth Edition has been revised as necessary to incorporate new developments in the law or to streamline the presentations. Other major changes and additions for this edition include the following:

- Chapter 4 (Business and the Constitution)—The chapter has been revised and updated to be more

business oriented. It has two new cases, four new *Cases in Point*, a new exhibit, and three new case problems. A *Managerial Strategy* feature on marriage equality and the constitution discusses United States Supreme Court decisions on this issue.

- Chapter 5 (Business Ethics)—This chapter contains two new cases, two new *Issue Spotters*, three new *Cases in Point* (including a case involving Tom Brady’s suspension from the NFL as a result of “deflategate”), and three new case problems. The chapter includes a section on business ethics and social media, and discusses stakeholders and corporate social responsibility. The chapter also provides step-by-step guidance on making ethical business decisions and includes materials on global business ethics. A new *Digital Update* feature examines whether employees should have the right to disconnect from their electronic devices after work hours.
- Chapter 8 (Intellectual Property Rights)—The materials on intellectual property rights have been thoroughly revised and updated to reflect the most current laws and trends. The 2016 case involves the Hustler Club and a trademark infringement claim between brothers. A *Digital Update* feature examines the problem of patent trolls. There are eleven new *Cases in Point*, including cases involving FedEx’s color and logo, Google’s digitalization of books, and how the Sherlock Holmes copyright fell into the public domain.
- Chapter 9 (Internet Law, Social Media, and Privacy)—This chapter, which was new to the last edition and covers legal issues that are unique to the Internet, has been thoroughly revised and updated for the Fourteenth Edition. It includes a new section on cyberstalking, two new cases, and a new *Digital Update* feature on whether employers can monitor employees’ social media use.
- Chapter 10 (Criminal Law and Cyber Crime)—This chapter includes three new cases, five new *Cases in Point*, three new examples, and four new case problems. A new *Managerial Strategy* feature discusses the criminalization of American business.
- Chapters 11 through 19 (the Contracts and E-Contracts unit)—In this unit, we have added fifteen new cases (including a *Spotlight Case* and several *Case Analysis* cases), twenty-four new *Cases in Point*, nine new *Examples*, and nineteen new case problems. We have also added new exhibits, graphic concept summaries, numbered lists, a new *Reviewing* feature, and a new *Managerial Strategy* on the commercial use of drones. These updates clarify and enhance our already superb contract law coverage.
- Chapters 20 through 23 (the first three chapters in the Domestic and International Sales and Lease Contracts unit)—We have streamlined and simplified our coverage of the Uniform Commercial Code and added six new cases (including a 2016 *Spotlight Case*). We have added fifteen new *Cases in Point* and five new *Examples* in these chapters to increase student comprehension. New exhibits, new business scenarios, and many new case problems have also been added.
- Chapter 24 (International and Space Law)—The last chapter in the unit on Domestic and International Sales and Lease Contracts has been expanded to include a new section on space law—international and domestic. All three cases presented are new to this edition, including a *Spotlight Case* on a United States Supreme Court decision concerning the Alien Tort Claims Act. The chapter also now covers the Trans-Pacific Partnership (TPP) and includes an *Ethics Today* feature on the domestic brewing of imported beer brands.
- Chapter 28 (Banking in the Digital Age)—We have updated this entire chapter to reflect the realities of banking in today’s digital world. All three cases are new and recent. There are three new *Cases in Point*, a new *Issue Spotter*, and three new case problems. A new *Digital Update* feature explains how electronic payment systems are reducing the use of checks.
- Chapters 29 through 31 (the Creditors’ Rights and Bankruptcy unit)—This unit has been revised to be more up to date and comprehensible. Each chapter in the unit has two new cases and a new feature. We have also streamlined the materials to focus on those concepts that students need to know. We have added new exhibits, concept summaries, key terms, *Examples*, and *Cases in Point* to better clarify concepts. Chapter 30 (Secured Transactions) was substantially reworked to clarify the general principles and exceptions. Chapter 31 (Bankruptcy Law) includes updated dollar amounts of various provisions of the Bankruptcy Code, six new *Cases in Point*, and an *Ethics Today* feature on whether there should be more relief for student loan debt.
- Chapter 32 (Agency Formation and Duties) and Chapter 33 (Agency Liability and Termination)—These two chapters have been updated to

reflect the realities of the gig economy in which many people are working as independent contractors. A new *Ethics Today* feature continues that emphasis with a discussion of whether Uber and Lyft drivers should be considered employees rather than independent contractors. There is also a new *Global Insight* feature in Chapter 33 concerning Islamic law and *respondeat superior*. In addition, new *Examples*, *Cases in Point*, and case problems have been added to help students comprehend the important issues and liability in agency relationships.

- Chapter 34 (Employment, Immigration, and Labor Law) and Chapter 35 (Employment Discrimination)—These two chapters covering employment law have been thoroughly updated to include discussions of legal issues facing employers today. Chapter 34 has three new cases, three new *Cases in Point*, three new *Examples* (including one involving wage claims of Oakland Raiders cheerleaders), and three new case problems. We have added two new features—an *Ethics Today* on whether employees should receive paid bathroom breaks and a *Managerial Strategy* on union organizing using company e-mail systems. Chapter 35 has a new section discussing discrimination based on military status and new coverage of same-sex discrimination and discrimination against transgender persons. All three cases are new. There are seven new *Cases in Point*, five new *Examples*, a new exhibit, and three new case problems. A *Digital Update* feature discusses hiring discrimination based on social media posts. We discuss relevant United States Supreme Court decisions affecting employment issues throughout both chapters.
- Chapters 36 through 42 (the Business Organizations unit)—This unit has been revised and updated to improve flow and clarity. We provide more practical information and recent examples. We start with small business forms, go on to partnerships, and then cover limited liability companies. We discuss corporations in Chapters 39 through 42. There are thirteen new cases in this unit and nineteen new *Cases in Point*. Five of the six chapters in the unit include new features. For instance, in Chapter 39, a *Global Insight* feature examines whether cloud computing has a nationality. We also discuss crowdfunding and venture capital in that chapter. We have added new exhibits and key terms throughout this unit as well. In the chapter on securities law (Chapter 42), we have updated the materials on Regulation A offerings because the cap went from 5 million to 50 million in 2015. We also discuss how to deal with the SEC’s new CEO pay-ratio rule in a *Managerial Strategy* feature.
- Chapter 43 through 47 (the Government Regulation unit)—This unit has been streamlined, updated, and simplified. There are eleven new cases and four new features. Chapter 44 (Consumer Law) and Chapter 46 (Antitrust Law) include all new cases, and both have been significantly updated with new coverage, *Examples*, and *Cases in Point*. A *Digital Update* in Chapter 44 deals with “native” ads on the Internet, and a *Digital Update* in Chapter 46 discusses the European Union’s antitrust complaint against Google.
- Chapter 48 (Personal Property and Bailments) and Chapter 49 (Real Property and Landlord-Tenant Law)—We have rearranged the materials in the property chapters somewhat and now cover fixtures in the real property chapter. Each chapter includes two new cases as well as a *Classic Case* or *Spotlight Case*. There are six new *Examples*, seven new *Cases in Point*, two new exhibits, and seven new case problems in these two chapters. Both chapters also include new features (an *Ethics Today* and a *Digital Update*).

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Through the years, we have enjoyed an ongoing correspondence with many of you who have found points on which you wish to comment. We continue to welcome all comments and promise to respond promptly. By incorporating your ideas, we can continue to write a business law text that is best for you and best for your students.

K.S.C.
R.L.M.
F.B.C.

To Philip,

*You are just like
your wine cellar—
aging very well.*

R.L.M.

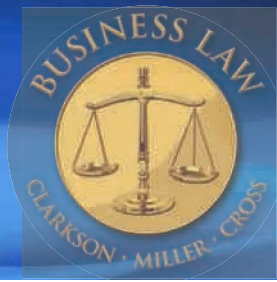
To my parents and sisters.

F.B.C.

The Legal Environment of Business



- 1.** Law and Legal Reasoning
- 2.** Courts and Alternative Dispute Resolution
- 3.** Court Procedures
- 4.** Business and the Constitution
- 5.** Business Ethics



CHAPTER 1

Law and Legal Reasoning

One of the most important functions of law in any society is to provide stability, predictability, and continuity so that people can know how to order their affairs. If any society is to survive, its citizens must be able to determine what is legally right and legally wrong. They must know what sanctions will be imposed on them if they commit wrongful acts. If they suffer harm as a result of others' wrongful acts, they must know how they can seek compensation. By setting forth the rights, obligations, and privileges of citizens, the law enables individuals to go about their business with confidence and a certain degree of predictability.

Although law has various definitions, they all are based on the

general observation that **law** consists of *enforceable rules governing relationships among individuals and between individuals and their society*. These “enforceable rules” may consist of unwritten principles of behavior established by a nomadic tribe. They may be set forth in a law code, such as the Code of Hammurabi in ancient Babylon (c. 1780 B.C.E.) or the law code of one of today's European nations. They may consist of written laws and court decisions created by modern legislative and judicial bodies, as in the United States. Regardless of how such rules are created, they all have one thing in common: they establish rights, duties, and privileges that are consistent with the values

and beliefs of their society or its ruling group.

In this introductory chapter, we first look at an important question for any student reading this text: How does the legal environment affect business decision making? We next describe the major sources of American law, the common law tradition, and some basic schools of legal thought. We conclude the chapter with sections offering practical guidance on several topics, including how to find the sources of law discussed in this chapter (and referred to throughout the text) and how to read and understand court opinions.

1-1 Business Activities and the Legal Environment

Laws and government regulations affect almost all business activities—from hiring and firing decisions to workplace safety, the manufacturing and marketing of products, business financing, and more. To make good business decisions, a basic knowledge of the laws and regulations governing these activities is beneficial—if not essential.

Realize also that in today's business world, a knowledge of “black-letter” law and what conduct can lead to legal **liability** is not enough. Businesspersons must develop critical thinking and legal reasoning skills so that they can evaluate how various laws might apply to a given situation and determine the best course of action. Businesspersons are also expected to make ethical decisions. Thus, the study of business law necessarily involves an ethical dimension.

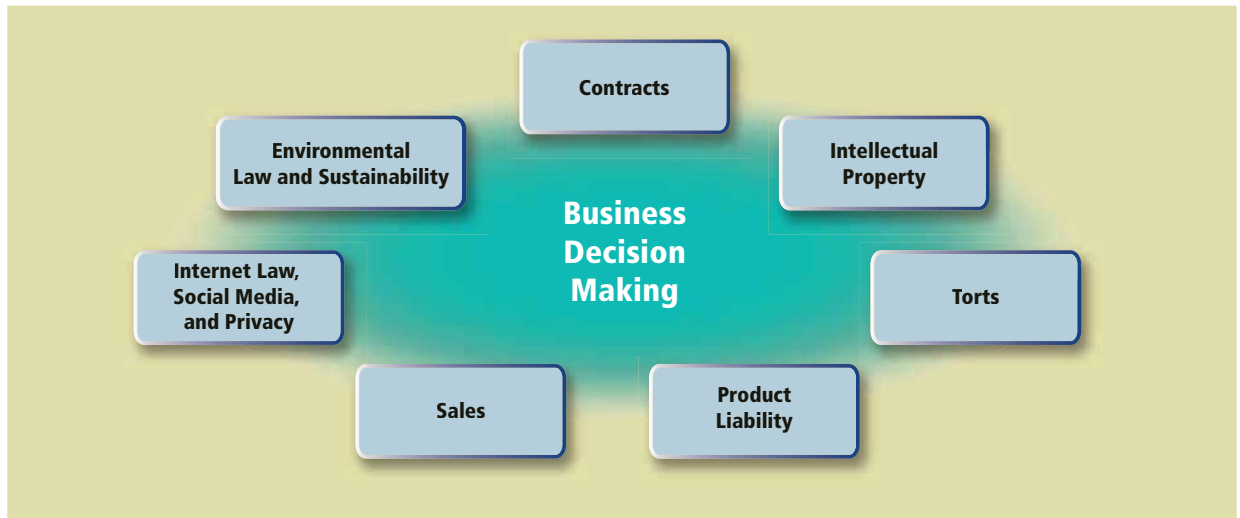
1-1a Many Different Laws May Affect a Single Business Decision

As you will note, each chapter in this text covers specific areas of the law and shows how the legal rules in each area affect business activities. Although compartmentalizing the law in this fashion promotes conceptual clarity, it does not indicate the extent to which a number of different laws may apply to just one decision. Exhibit 1-1 illustrates the various areas of the law that may influence business decision making.

■ **EXAMPLE 1.1** When Mark Zuckerberg started Facebook as a Harvard student, he probably did not imagine all the legal challenges his company would face as a result of his business decisions.

- Shortly after Facebook was launched, others claimed that Zuckerberg had stolen their ideas for a social networking site. Their claims involved alleged theft of intellectual property, fraudulent misrepresentation, and

EXHIBIT 1–1 Areas of the Law That Can Affect Business Decision Making



violations of partnership law and securities law. Facebook ultimately paid \$65 million to settle those claims out of court.

- Facebook has been sued repeatedly for violating users' privacy (and federal laws) by tracking their Web site usage and by scanning private messages for purposes of data mining and user profiling. A class-action suit filed in Europe alleges that Facebook's data-use policies violate the law of the European Union. Facebook might have to pay millions in damages in this case.
- Facebook's business decisions have also come under scrutiny by federal regulators, such as the Federal Trade Commission (FTC). The company settled a complaint filed by the FTC alleging that Facebook had failed to keep "friends" lists and other user information private. ■

1-1b Ethics and Business Decision Making

Merely knowing the areas of law that may affect a business decision is not sufficient in today's business world. Today, business decision makers need to consider not just whether a decision is legal, but also whether it is ethical.

Ethics generally is defined as the principles governing what constitutes right or wrong behavior. Often, as in several of the claims against Facebook discussed above, disputes arise in business because one party feels that he or she has been treated unfairly. Thus, the underlying reason for bringing some lawsuits is a breach of ethical duties (such as when a partner or employee attempts to secretly take advantage of a business opportunity).

Throughout this text, you will learn about the relationship between the law and ethics, as well as about some of the types of ethical questions that arise in business. For instance, all of the new unit-ending *Unit Application and Ethics* features include an *Ethical Connection* section that explores the ethical dimensions of a topic treated within the unit. We have also included *Ethical Questions* for each unit, as well as within the critical thinking sections of many of the cases presented in this text. *Ethics Today* features, which focus on ethical considerations in today's business climate, appear in selected chapters, including this chapter. *A Question of Ethics* case problem is included at the end of every chapter to introduce you to the ethical aspects of specific cases involving real-life situations.

1-2 Sources of American Law

American law has numerous sources. Often, these sources of law are classified as either primary or secondary.

Primary sources of law, or sources that establish the law, include the following:

1. The U.S. Constitution and the constitutions of the various states.
2. Statutory law—including laws passed by Congress, state legislatures, or local governing bodies.
3. Regulations created by administrative agencies, such as the Federal Trade Commission.
4. Case law and common law doctrines.

We describe each of these important sources of law in the following pages.

Secondary sources of law are books and articles that summarize and clarify the primary sources of law. Examples include legal encyclopedias, treatises, articles in law reviews, and compilations of law, such as the *Restatements of the Law* (which will be discussed later). Courts often refer to secondary sources of law for guidance in interpreting and applying the primary sources of law discussed here.

1-2a Constitutional Law

The federal government and the states have separate written constitutions that set forth the general organization, powers, and limits of their respective governments. **Constitutional law** is the law as expressed in these constitutions.

According to Article VI of the U.S. Constitution, the Constitution is the supreme law of the land. As such, it is the basis of all law in the United States. A law in violation of the Constitution, if challenged, will be declared unconstitutional and will not be enforced, no matter what its source. Because of its importance in the American legal system, we present the complete text of the U.S. Constitution in Appendix B.

The Tenth Amendment to the U.S. Constitution reserves to the states all powers not granted to the federal government. Each state in the union has its own constitution. Unless it conflicts with the U.S. Constitution or a federal law, a state constitution is supreme within the state's borders.

1-2b Statutory Law

Laws enacted by legislative bodies at any level of government, such as statutes passed by Congress or by state legislatures, make up the body of law known as **statutory law**. When a legislature passes a statute, that statute ultimately is included in the federal code of laws or the relevant state code of laws.

Statutory law also includes local **ordinances**—regulations passed by municipal or county governing units to deal with matters not covered by federal or state law. Ordinances commonly have to do with city or county land use (zoning ordinances), building and safety codes, and other matters affecting the local community.

A federal statute, of course, applies to all states. A state statute, in contrast, applies only within the state's borders. State laws thus may vary from state to state. No federal statute may violate the U.S. Constitution, and no state statute or local ordinance may violate the U.S. Constitution or the relevant state constitution.

Uniform Laws During the 1800s, the differences among state laws frequently created difficulties for

businesspersons conducting trade and commerce among the states. To counter these problems, a group of legal scholars and lawyers formed the National Conference of Commissioners on Uniform State Laws, or NCCUSL (www.uniformlaws.org), in 1892. The NCCUSL still exists today. Its object is to draft **uniform laws** (model statutes) for the states to consider adopting.

Each state has the option of adopting or rejecting a uniform law. *Only if a state legislature adopts a uniform law does that law become part of the statutory law of that state.* Note that a state legislature may adopt all or part of a uniform law as it is written, or the legislature may rewrite the law however the legislature wishes. Hence, even though many states may have adopted a uniform law, those states' laws may not be entirely "uniform."

The earliest uniform law, the Uniform Negotiable Instruments Law, was completed by 1896 and adopted in every state by the 1920s (although not all states used exactly the same wording). Over the following decades, other acts were drawn up in a similar manner. In all, more than two hundred uniform acts have been issued by the NCCUSL since its inception. The most ambitious uniform act of all, however, was the Uniform Commercial Code.

The Uniform Commercial Code One of the most important uniform acts is the Uniform Commercial Code (UCC), which was created through the joint efforts of the NCCUSL and the American Law Institute.¹ The UCC was first issued in 1952 and has been adopted in all fifty states,² the District of Columbia, and the Virgin Islands.

The UCC facilitates commerce among the states by providing a uniform, yet flexible, set of rules governing commercial transactions. Because of its importance in the area of commercial law, we cite the UCC frequently in this text. We also present the full UCC in Appendix C. From time to time, the NCCUSL revises the articles contained in the UCC and submits the revised versions to the states for adoption.

1-2c Administrative Law

Another important source of American law is **administrative law**, which consists of the rules, orders, and decisions of administrative agencies. An **administrative agency** is a federal, state, or local government agency established to perform a specific function. Administrative law and procedures constitute a dominant element in the regulatory environment of business.

1. This institute was formed in the 1920s and consists of practicing attorneys, legal scholars, and judges.

2. Louisiana has not adopted Articles 2 and 2A (covering contracts for the sale and lease of goods), however.

Rules issued by various administrative agencies now affect almost every aspect of a business's operations. Regulations govern a business's capital structure and financing, its hiring and firing procedures, its relations with employees and unions, and the way it manufactures and markets its products. Regulations enacted to protect the environment also often play a significant role in business operations.

Federal Agencies At the national level, the cabinet departments of the executive branch include numerous **executive agencies**. The U.S. Food and Drug Administration, for instance, is an agency within the U.S. Department of Health and Human Services. Executive agencies are subject to the authority of the president, who has the power to appoint and remove their officers.

There are also major **independent regulatory agencies** at the federal level, such as the Federal Trade Commission, the Securities and Exchange Commission, and the Federal Communications Commission. The president's power is less pronounced in regard to independent agencies, whose officers serve for fixed terms and cannot be removed without just cause.

State and Local Agencies There are administrative agencies at the state and local levels as well. Commonly, a state agency (such as a state pollution-control agency) is created as a parallel to a federal agency (such as the Environmental Protection Agency). Just as federal statutes take precedence over conflicting state statutes, federal agency regulations take precedence over conflicting state regulations.

1-2d Case Law and Common Law Doctrines

The rules of law announced in court decisions constitute another basic source of American law. These rules include interpretations of constitutional provisions, of statutes enacted by legislatures, and of regulations created by administrative agencies.

Today, this body of judge-made law is referred to as **case law**. Case law—the doctrines and principles announced in cases—governs all areas not covered by statutory law or administrative law and is part of our common law tradition. We look at the origins and characteristics of the common law tradition in some detail in the pages that follow.

See Concept Summary 1.1 for a review of the sources of American law.

Concept Summary 1.1

Sources of American Law

Constitutional Law

- Law as expressed in the U.S. Constitution or state constitutions.
- The U.S. Constitution is the supreme law of the land.
- State constitutions are supreme within state borders to the extent that they do not conflict with the U.S. Constitution.

Statutory Law

- Statutes (including uniform laws) and ordinances enacted by federal, state, and local legislatures.
- Federal statutes may not violate the U.S. Constitution.
- State statutes and local ordinances may not violate the U.S. Constitution or the relevant state constitution.

Administrative Law

- The rules, orders, and decisions of federal, state, and local administrative agencies.

Case Law and Common Law Doctrines

- Judge-made law, including interpretations of constitutional provisions, of statutes enacted by legislatures, and of regulations created by administrative agencies.

1-3 The Common Law Tradition

Because of our colonial heritage, much of American law is based on the English legal system. Knowledge of this tradition is crucial to understanding our legal system today because judges in the United States still apply common law principles when deciding cases.

1-3a Early English Courts

After the Normans conquered England in 1066, William the Conqueror and his successors began the process of unifying the country under their rule. One of the means they used to do this was the establishment of the king's courts, or *curiae regis*.

Before the Norman Conquest, disputes had been settled according to the local legal customs and traditions in various regions of the country. The king's courts sought to establish a uniform set of customs for the country as a whole. What evolved in these courts was the beginning of the **common law**—a body of general rules that applied throughout the entire English realm. Eventually, the common law tradition became part of the heritage of all nations that were once British colonies, including the United States.

Courts of Law and Remedies at Law The early English king's courts could grant only very limited kinds of **remedies** (the legal means to enforce a right or redress a wrong). If one person wronged another in some way, the king's courts could award as compensation one or more of the following: (1) land, (2) items of value, or (3) money.

The courts that awarded this compensation became known as **courts of law**, and the three remedies were called **remedies at law**. (Today, the remedy at law normally takes the form of monetary **damages**—an amount given to a party whose legal interests have been injured.) This system made the procedure for settling disputes more uniform. When a complaining party wanted a remedy other than economic compensation, however, the courts of law could do nothing, so “no remedy, no right.”

Courts of Equity When individuals could not obtain an adequate remedy in a court of law, they petitioned the king for relief. Most of these petitions were decided by an adviser to the king, called a *chancellor*, who had the power to grant new and unique remedies. Eventually, formal chancery courts, or **courts of equity**, were established. *Equity* is a branch of law—founded on notions of justice

and fair dealing—that seeks to supply a remedy when no adequate remedy at law is available.

Remedies in Equity The remedies granted by the equity courts became known as **remedies in equity**, or equitable remedies. These remedies include specific performance, injunction, and rescission. *Specific performance* involves ordering a party to perform an agreement as promised. An *injunction* is an order to a party to cease engaging in a specific activity or to undo some wrong or injury. *Rescission* is the cancellation of a contractual obligation. We will discuss these and other equitable remedies in more detail in later chapters.

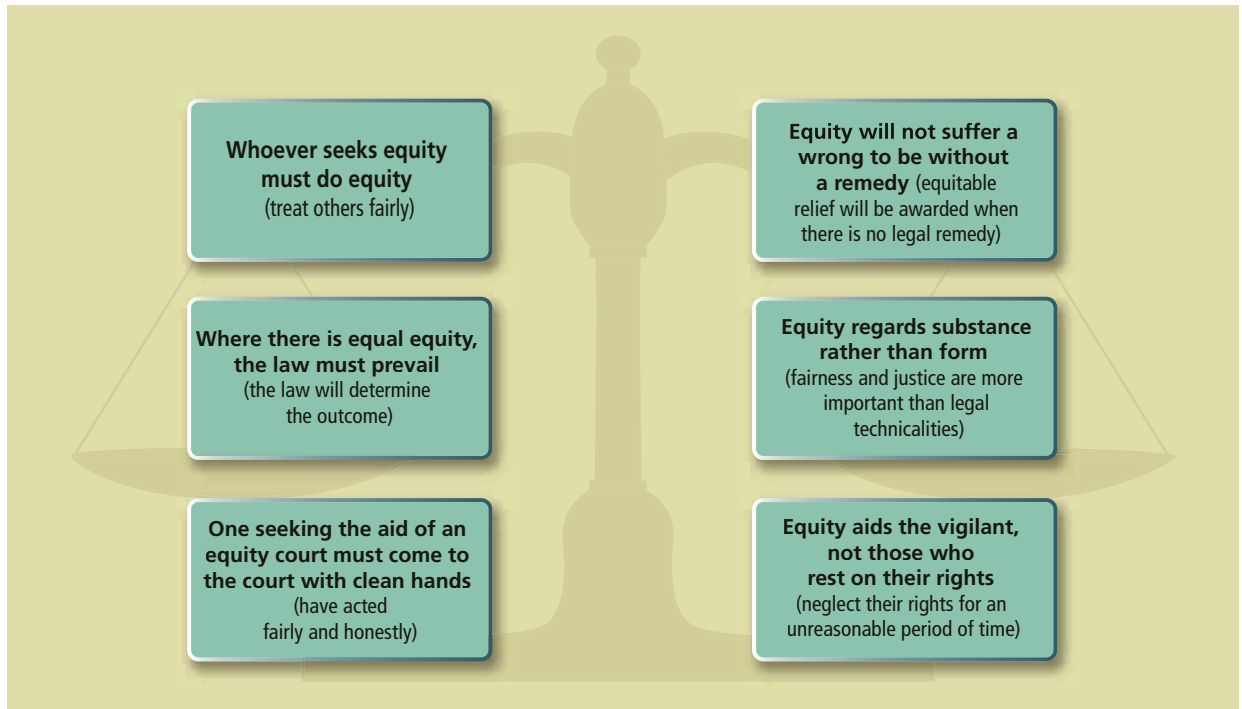
As a general rule, today's courts, like the early English courts, will not grant equitable remedies unless the remedy at law—monetary damages—is inadequate. ■ **EXAMPLE 1.2** Ted forms a contract (a legally binding agreement) to purchase a parcel of land that he thinks will be perfect for his future home. The seller **breaches** (fails to fulfill) this agreement. Ted could sue the seller for the return of any deposits or down payment he might have made on the land, but this is not the remedy he really wants. What Ted wants is to have a court order the seller to perform the contract. In other words, Ted will seek the equitable remedy of specific performance because monetary damages are inadequate in this situation. ■

Equitable Maxims In fashioning appropriate remedies, judges often were (and continue to be) guided by so-called **equitable maxims**—propositions or general statements of equitable rules. Exhibit 1-2 lists some important equitable maxims.

The last maxim listed in the exhibit—“Equity aids the vigilant, not those who rest on their rights”—merits special attention. It has become known as the equitable doctrine of **laches** (a term derived from the Latin *laxus*, meaning “lax” or “negligent”), and it can be used as a defense. A **defense** is an argument raised by the **defendant** (the party being sued) indicating why the **plaintiff** (the suing party) should not obtain the remedy sought. (Note that in equity proceedings, the party bringing a lawsuit is called the **petitioner**, and the party being sued is referred to as the **respondent**.)

The doctrine of laches arose to encourage people to bring lawsuits while the evidence was fresh. What constitutes a reasonable time, of course, varies according to the circumstances of the case. Time periods for different types of cases are now usually fixed by **statutes of limitations**. After the time allowed under a statute of limitations has expired, no action (lawsuit) can be brought, no matter how strong the case was originally.

EXHIBIT 1–2 Equitable Maxims



1–3b Legal and Equitable Remedies Today

The establishment of courts of equity in medieval England resulted in two distinct court systems: courts of law and courts of equity. The courts had different sets of judges and granted different types of remedies. During the nineteenth century, however, most states in the United States adopted rules of procedure that resulted in the combining of courts of law and equity. A party now may request both legal and equitable remedies in the same action, and the trial court judge may grant either or both forms of relief.

The distinction between legal and equitable remedies remains relevant to students of business law, however, because these remedies differ. To seek the proper remedy for a wrong, you must know what remedies are available. Additionally, certain vestiges of the procedures used when there were separate courts of law and equity still exist. For instance, a party has the right to demand a jury trial in an action at law, but not in an action in equity. Exhibit 1–3 summarizes the procedural differences (applicable in most states) between an action at law and an action in equity.

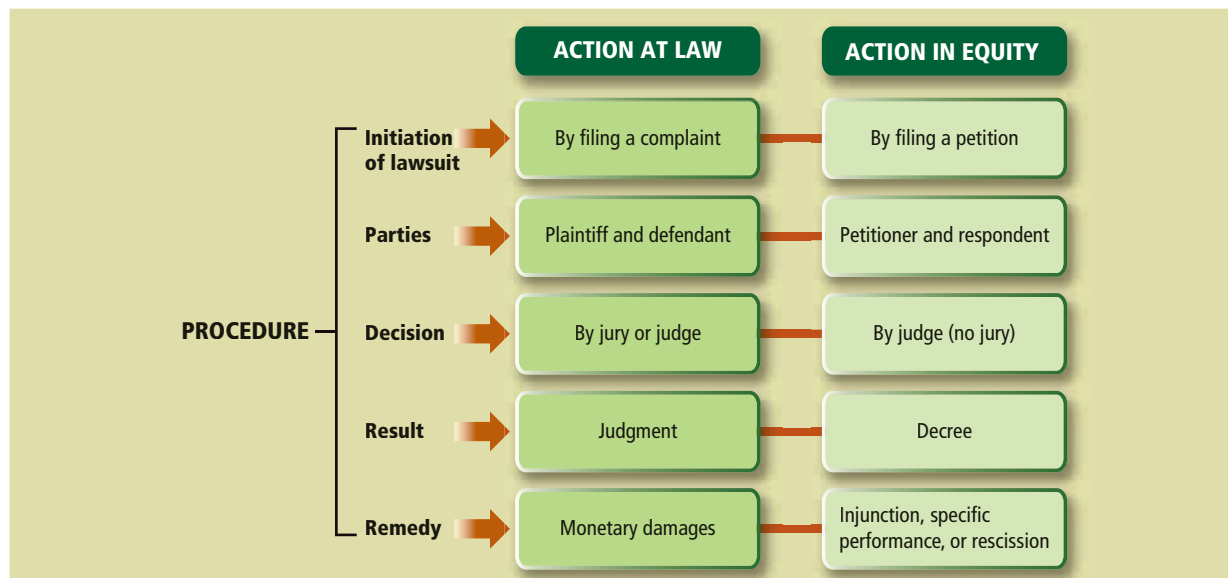
1–3c The Doctrine of *Stare Decisis*

One of the unique features of the common law is that it is *judge-made law*. The body of principles and doctrines that form the common law emerged over time as judges decided legal controversies.

Case Precedents and Case Reporters When possible, judges attempted to be consistent and to base their decisions on the principles suggested by earlier cases. They sought to decide similar cases in a similar way, and they considered new cases with care because they knew that their decisions would make new law. Each interpretation became part of the law on the subject and thus served as a legal **precedent**. A precedent is a decision that furnishes an example or authority for deciding subsequent cases involving identical or similar legal principles or facts.

In the early years of the common law, there was no single place or publication where court opinions, or written decisions, could be found. By the fourteenth century, portions of the most important decisions from each year were being gathered together and recorded in *Year Books*, which became useful references for lawyers and judges. In the

EXHIBIT 1–3 Procedural Differences between Actions at Law and Actions in Equity



sixteenth century, the *Year Books* were discontinued, and other forms of case publication became available. Today, cases are published, or “reported,” in volumes called **reporters**, or *reports*—and are also posted online. We describe today’s case reporting system in detail later in this chapter.

Stare Decisis and the Common Law Tradition

The practice of deciding new cases with reference to former decisions, or precedents, became a cornerstone of the English and American judicial systems. The practice formed a doctrine known as *stare decisis*,³ a Latin phrase meaning “to stand on decided cases.”

Under the doctrine of *stare decisis*, judges are obligated to follow the precedents established within their jurisdictions. The term *jurisdiction* refers to a geographic area in which a court or courts have the power to apply the law. Once a court has set forth a principle of law as being applicable to a certain set of facts, that court must apply the principle in future cases involving similar facts. Courts of lower rank (within the same jurisdiction) must do likewise. Thus, *stare decisis* has two aspects:

1. A court should not overturn its own precedents unless there is a compelling reason to do so.
2. Decisions made by a higher court are binding on lower courts.

Controlling Precedents Precedents that must be followed within a jurisdiction are called *controlling*

precedents. Controlling precedents are a type of binding authority. A **binding authority** is any source of law that a court must follow when deciding a case. Binding authorities include constitutions, statutes, and regulations that govern the issue being decided, as well as court decisions that are controlling precedents within the jurisdiction. United States Supreme Court case decisions, no matter how old, remain controlling until they are overruled by a subsequent decision of the Supreme Court or changed by further legislation or a constitutional amendment.

Stare Decisis and Legal Stability The doctrine of *stare decisis* helps the courts to be more efficient because, if other courts have analyzed a similar case, their legal reasoning and opinions can serve as guides. *Stare decisis* also makes the law more stable and predictable. If the law on a subject is well settled, someone bringing a case can usually rely on the court to rule based on what the law has been in the past. See this chapter’s *Ethics Today* feature for a discussion of how courts often defer to case precedent even when they disagree with the reasoning in the case.

Although courts are obligated to follow precedents, sometimes a court will depart from the rule of precedent if it decides that the precedent should no longer be followed. If a court decides that a ruling precedent is simply incorrect or that technological or social changes have rendered the precedent inapplicable, the court might rule contrary to the precedent. Cases that overturn precedent often receive a great deal of publicity.

■ **CASE IN POINT 1.3** The United States Supreme Court expressly overturned precedent in the case of

3. Pronounced *ster-ay dih-si-ses*.

ETHICS TODAY

Stare Decisis versus Spider-Man

Supreme Court Justice Elena Kagan, in a recent decision involving Marvel Comics' Spider-Man, ruled that, "What we can decide, we can undecide. But *stare decisis* teaches that we should exercise that authority sparingly." Citing a Spider-Man comic book, she went on to say that "in this world, with great power there must also come—great responsibility."^a In its decision in the case—*Kimble v. Marvel Entertainment, LLC*—the Supreme Court applied *stare decisis* and ruled against Stephen Kimble, the creator of a toy related to the Spider-Man figure.^b



When Kimble sued Marvel for patent infringement, he won. The result was a settlement that involved a licensing agreement between Kimble and Marvel with a lump-sum payment plus a royalty to Kimble of 3 percent of all sales of the toy. The agreement did not specify an end date for royalty payments to Kimble, and Marvel later sued to have the payments stop after the patent expired, consistent with the Court's earlier *Brulotte* decision.

A majority of the Supreme Court justices agreed with Marvel. As Justice Kagan said in the opinion, "Patents endow their holders with certain super powers, but only for a limited time." The court further noted that the fifty-year-old *Brulotte* decision was perhaps based on what today is an outmoded understanding of economics. That decision, according to some, may even hinder competition and innovation. But "respecting *stare decisis* means sticking to some wrong decisions."

Can a Patent Involving Spider-Man Last Super Long?

A patent is an exclusive right granted to the creator of an invention. Under U.S. law, patent owners generally possess that right for twenty years. Patent holders can license the use of their patents as they see fit during that period. In other words, they can allow others (called *licensees*) to use their invention in return for a fee (called *royalties*).

More than fifty years ago, the Supreme Court ruled in its *Brulotte* decision that a licensee cannot be forced to pay royalties to a patent holder after the patent has expired.^c So if a licensee signs a contract to continue to pay royalties after the patent has expired, the contract is invalid and thus unenforceable.

At issue in the *Kimble* case was a contract signed between Marvel Entertainment and Kimble, who had invented a toy made up of a glove equipped with a valve and a canister of pressurized foam. The patented toy allowed people to shoot fake webs intended to look like Spider-Man's. In 1990, Kimble tried to cut a deal with Marvel Entertainment concerning his toy, but he was unsuccessful. Then Marvel started selling its own version of the toy.

The Ethical Side

In a dissenting opinion, Supreme Court Justice Samuel A. Alito, Jr., said, "The decision interferes with the ability of parties to negotiate licensing agreements that reflect the true value of a patent, and it disrupts contractual expectations. *Stare decisis* does not require us to retain this baseless and damaging precedent. . . . *Stare decisis* is important to the rule of law, but so are correct judicial decisions."

In other words, *stare decisis* holds that courts should adhere to precedent in order to promote predictability and consistency. But in the business world, shouldn't parties to contracts be able to, for example, allow a patent licensee to make smaller royalty payments that exceed the life of the patent? Isn't that a way to reduce the yearly costs to the licensee? After all, the licensee may be cash-strapped in its initial use of the patent. Shouldn't the parties to a contract be the ones to decide how long the contract should last?

Critical Thinking *When is the Supreme Court justified in not following the doctrine of stare decisis?*

a. "Spider-Man," *Amazing Fantasy* No. 15 (1962), p. 13.
b. 576 U.S. ___, 135 S.Ct. 2401, 192 L.Ed.2d 463 (2015).
c. *Brulotte v. Thys Co.*, 379 U.S. 29, 85 S.Ct. 176 (1964).

Brown v. Board of Education of Topeka.⁴ The Court concluded that separate educational facilities for whites and blacks, which it had previously upheld as constitutional,⁵

were inherently unequal. The Supreme Court's departure from precedent in this case received a tremendous amount of publicity as people began to realize the ramifications of this change in the law. ■

Note that a lower court will sometimes avoid applying a precedent set by a higher court in its jurisdiction by

4. 347 U.S. 483, 74 S.Ct. 686, 98 L.Ed. 873 (1954).

5. See *Plessy v. Ferguson*, 163 U.S. 537, 16 S.Ct. 1138, 41 L.Ed. 256 (1896).