



UNIT ONE

Fundamentals of the Legal Environment of Business

CHAPTER 1 Legal Foundations

APPENDIX TO CHAPTER 1 A Business Student's Guide to Understanding Cases and Finding the Law

CHAPTER 2 Business and the Constitution

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CHAPTER

Legal Foundations

learning objectives

After studying this chapter, students who have mastered the material will be able to:

- 1-1** Understand the broad definition and origins of law.
- 1-2** List and explain the purposes of law.
- 1-3** Explain the importance and benefits of legal awareness for business owners and managers in creating strategy and adding value to a company.
- 1-4** Articulate the role of counsel in legal decision making in a business context.
- 1-5** Recognize, explain, and give examples of sources of American law.
- 1-6** Understand the legal doctrine of stare decisis.
- 1-7** Classify the law into several broad categories.
- 1-8** Differentiate between the concepts of law and equity.
- 1-9** Identify and apply important equitable maxims.



Undertaking the study of law may seem overwhelming. Legal doctrines and rules can be complex and difficult to navigate. Yet the law impacts many facets of our daily life both at home and at work. This textbook is designed to make studying the law more *manageable* by examining legal issues that are most commonly encountered in the business environment. In fact, studies have shown that business owners and managers who have a high level of legal insight create *value* for their business and recognize legal challenges as business planning opportunities. This legal awareness may be gained only by understanding important legal doctrines and processes. Applying this knowledge allows managers to limit risk and incorporate the law into their business strategies. This chapter introduces students to the foundations of the law and explains why the application of legal doctrines is an important part of the business environment. Specifically, in this chapter students will learn:

- How legal issues impact business planning and strategy.
- The foundations, definitions, and scope of various primary and secondary sources of law.
- Categories of law.

INTRODUCTION TO LAW LO 1-1

What Is Law?

The term **law** has been defined in a variety of ways throughout recorded history. A generally accepted

generic definition of the law is a *body of rules of action or conduct prescribed by controlling authority and having legal binding force*.¹ When studying law in any context, it is important to think of the law in broad terms. While many equate the law with stacks of neatly bound volumes of codes in a library, this is only one component of a much larger body of law. Law may be set down in a written code as prescribed by an elected legislative body, but also takes the form of judicial decisions and actions of government agencies. While there are many sources of American law, the common characteristic of the current state of law is that it creates *duties*, *obligations*, and *rights* that reflect accepted views of a given society. Much of the origins of the law dealt with issues related to ownership of property, but modern legal doctrines have evolved into a relatively complex system of principles and protections. Most importantly, the law also provides a mechanism to resolve disputes arising from those duties and rights and allows parties to enforce promises in a court of law. Law is often classified by subject matter so that one refers to certain rules regarding agreements as *contract law* or certain laws that regulate certain rights of employees as *employment law*.

Jurisprudence

Jurisprudence, roughly defined as the science and philosophy of law, defines several schools of

¹*Black's Law Dictionary.*

thought that are used to describe various approaches to the appropriate function of law and how legal doctrines should be developed and applied. Most schools of jurisprudential thought center on how legal rights are recognized. *Natural law* proponents argue that a system of moral values, which are inherent in humankind, form the basis for all law and those certain principles are of a *higher* authority than national laws (laws defined by a governing body).² *Positivists* believe in a specific set of agreed-upon laws that are enforced *uniformly* and strictly unless the law is changed expressly via the government. They reject the natural law notion of a higher authority that surpasses national law. *Legal realism* began to take shape in the United States after World War I and is based on the concept that law is a *social institution* that should be used to promote fairness by taking into account social and economic realities when arriving at legal conclusions. Perhaps the most dramatic example of the legal realism school of thought in practice was the U.S. Supreme Court's formal recognition during the civil rights era of its role in achieving equality for all Americans by interpreting the Constitution as protecting certain rights that courts had previously never recognized.

LO 1-2 Purposes of Law

Although the most visible function of the law on a day-to-day basis is to provide for some system of order that defines crimes and levies punishment for violation of the crimes, there are many other purposes of recognizing a uniform system of laws. The origins of recorded law were initially a collection of rules of powerful tribal chieftains intended to perpetuate domination and power of their authority with little consideration for rights of individuals. However, over the better part of three millennia, the purpose of law evolved substantially into ensuring consistency and fairness. In the United States, lawmakers have increasingly embraced legal mechanisms, such as antidiscrimination laws, to help promote equality and justice in society and especially in education and in the workplace. The law also sets out a system for resolving disputes by providing a basis for deciding the legal interests and rights of the parties. For purposes of studying the impact of law on business, it is important to recognize that the law also serves as an important catalyst for commerce by promoting *good faith dealing* among merchants and consumers and giving some degree of *reliability* that can be considered in business planning and commercial transactions.

For example, assume Clothing Manufacturing Corporation (CMC) orders 100 bales of wool from Woolpack, Inc., in anticipation of a large order for winter clothing from retail outlets. The laws that govern the various transactions that arise from the CMC-Woolpack agreement set a standard of good faith and provide both parties the confidence necessary to set the business process in motion (e.g., financial, operations, marketing). Moreover, the merchants may rely on the courts if either party needs to recoup any losses resulting from the other party's unlawful actions.

Language of the Law

In order to maximize the value of interaction between business owners/managers and attorneys, a basic understanding of legal terminology is useful. Students studying business law face the task of learning legal syntax at the same time as they learn how to apply the legal doctrines in a business context. This is analogous to learning a complicated subject matter in a foreign language, yet it is manageable with careful study. Legal terms are sometimes referred to as *jargon* or *legalese*, but having a working knowledge of some common legal terminology is an important step to mastering the material. Although much of the language of the law has Latin roots, the terminology is primarily a combination of Latin, early and



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²Aristotle was perhaps the most famous advocate of the natural law theory.

modern English, and French. The vocabulary of American law is drawn from the various cultures and events that shaped American history. To facilitate your understanding of legal expression, important legal terms are highlighted throughout the text, summarized at the end of each chapter, and also featured alphabetically in the glossary. The authoritative source for legal terms is *Black's Law Dictionary*, first published in 1891. There are also several websites that provide definitions and examples for legal terms.

LEGAL DECISIONS IN A BUSINESS ENVIRONMENT: THEORY TO PRACTICE

LO 1-3

While an in-depth understanding of the various areas of law is a vast undertaking requiring years of intensive study, the primary objective of this textbook is to cover a variety of legal topics that are most commonly encountered in the business environment. However, developing legal insight by understanding the fundamentals of legal theory and how they may impact business is only a first step in learning how legal decisions should be made in a business context. The second step involves learning to *apply* legal theories in practice and recognizing that having legal awareness may present opportunities for proactive business planning, empowering business owners and managers to limit liability, gain a competitive edge, and add value to the business. Relying exclusively on attorneys to drive the legal decision-making process in the context of business both is expensive and involves the significant risk that a decision will be made without sufficient knowledge of business operations, objectives, and current economic realities. Instead, studies and research indicate that when managers work *cooperatively* with their attorney, the results contribute to better strategic business decisions that add value to the business. For example,

KEY POINT

Learning to apply legal awareness in practice involves recognizing opportunities for proactive business planning, limiting liability, gaining a competitive edge, and adding value to the business.



Management teams with legal insight add value to their company by limiting liability and identifying opportunities.

recognizing that having a code of conduct for employees and creating a standardized procedure for hiring new employees are issues that a good manager should view as essential, attorneys regularly play a part in ensuring compliance with applicable federal, state, and local laws. Later in this chapter, we will discuss a mechanism that business owners and managers may use to spot legal issues, apply an appropriate analysis, decide on alternative solutions, and plan a legal and ethical course of action that limits liability and maximizes business opportunities.

LO 1-4 Legal Insight and Business Strategy

To understand the way various areas of the law impact business and the importance of having legal insight in a business context, let's examine a typical business planning process. Suppose that the management team at Indiana Printing Company (IPC) is planning to expand its existing business into new markets. The team considers several options and will have to have a sufficient understanding of the legal risks and business opportunities associated with each option. Table 1.1 sets out possible options for IPC's expansion and some of the potential legal impacts for each option.

The list of legal issues in Table 1.1 is meant to be illustrative and not exhaustive. Indeed, issues regarding negligence, criminal law, administrative law, bankruptcy, consumer protection, agency, and many others may present themselves before, during, or after the transaction is complete.

Role of Counsel

Although this textbook emphasizes understanding legal issues in the context of business decision making, this is not to suggest that an attorney's role in this process is diminished—quite the opposite. The content, features, and exercises contained in this textbook emphasize that working closely with a business attorney results in business opportunities, reduced costs, and limitation of risk and liability. Attorneys, particularly in a business context, may also be referred to as **counsel**. Business owners and managers work with counsel in one of two formats. For larger companies or companies that have extraordinary regulatory burdens (such as complying with securities or patent laws), counsel may very well be a part of the executive or midlevel management team. These attorneys are referred to as *in-house counsel* and usually have the title “general counsel” at the executive management level (e.g., vice president and general counsel). Depending on the size and complexity of the company, the general counsel may also supervise one or more attorneys, usually with the title “associate counsel.” Additionally, the general counsel may also serve as a corporate officer of the company, called the secretary, who is responsible for record keeping and complying with notice and voting requirements for the board of directors.³ The general counsel is also responsible for selecting and supervising lawyers from outside law firms when a particular field of expertise is needed, such as a trial lawyer (also called a *litigator*).

The majority of companies, however, rely on attorneys employed by *law firms* for their legal needs. These attorneys devote a significant amount of their professional time to advising businesses on issues such as formation, governance, labor and employment laws, regulatory agency compliance, legal transactions (such as an acquisition), intellectual property (such as trademarks or patents), and other legal issues important to business operations. These attorneys (known as *business lawyers* or *corporate lawyers*) rarely if ever appear in court or perform other tasks that are associated with lawyers in the minds of the general public. Indeed, the law has become increasingly complex and specialized. Therefore, it is not unusual that more than one attorney's advice is needed when facing a significant

Legal Speak >>)

Retainer Fee Some law firms handle certain legal matters on a retainer-fee basis. Although the practice is becoming increasingly rare, a retainer fee is an advanced payment by a client that ensures the availability of an attorney to handle general legal matters. If a business owner or manager has legal questions or requires representation, the attorney's charges are deducted from the retainer fee. While costs exceeding the retainer are due from the client, any unused retainer-fee balance is either rolled over into the next billing cycle or forfeited according to the initial fee agreement.

³The legal structure of corporations and other business entities is discussed in detail in Unit Three.

TABLE 1.1 Expansion Options and Potential Legal Impacts

Option	Area of Law	Potential Legal Impact
<p><i>Expansion through acquisition of another company.</i> One common way to expand is to purchase an existing business entity through an acquisition of assets or of stock.</p>	■ Contracts	■ Governs negotiations and agreements for the acquisition.
	■ Property/ environmental	■ If the acquisition involves any land purchase, real estate law (such as zoning) and environmental law.
	■ Employment and labor	■ The hiring of new employees by IPC (even former employees of the target company) or the layoff of IPC or target-company employees must be done in conformance with state and federal employment and labor laws.
	■ Tax	■ The transaction may create tax liability under local, state, and/or federal laws.
	■ Antitrust	■ If the acquisition results in IPC's gaining too much market share, federal antitrust laws must be considered and preacquisition approvals may be needed from the government.
<p><i>Expansion through introducing and aggressively marketing a new product line.</i> Expanding through marketing of a new product line generally involves raising sufficient capital to properly develop, manufacture, and go to market.</p>	■ Securities law	■ Any solicitation by IPC to sell shares of its business to the public is highly regulated by securities laws.
	■ Intellectual property	■ In order to maintain its competitive edge, IPC will need to put measures in place to help guarantee protection of ideas and processes by trade secret law; the final design may be protected by patent law.
	■ Administrative law	■ Federal regulatory agencies have guidelines for advertising and labeling of products.
<p><i>Expansion through aggressive integration of a highly interactive website and e-marketing campaigns including international markets.</i> In light of the growth in e-commerce, some companies find this to be the most cost-efficient method of expansion.</p>	■ Jurisdiction	■ Website expansion may result in IPC's being subject to the jurisdiction of more out-of-state courts than did the previous business model.
	■ International law	■ IPC may be subject to international agreements and treaties regarding sales and intellectual property.

legal issue such as an employment discrimination lawsuit or when obtaining financing for a corporation from the general public through the sale of stock. Law firms vary greatly in size, from those that have one or just a few lawyers in a local or regional practice to firms that have hundreds of lawyers spread throughout the globe. In a business context, law firms bill clients based on an hourly rate that is tied to an individual lawyer's experience, her reputation in the field, and the market being served (with large cities that are the center of business operations having higher rates).

✓ **Self-Check** Role of Counsel

What advice might Adams seek from an attorney in the following situations?

1. Adams sells custom-designed T-shirts from his basement apartment. The business begins to turn a profit.
2. Adams wants to expand his T-shirt business by renting a kiosk in a local mall and hiring Baker.
3. Adams wants to obtain trademark protection for his products.
4. Baker offers Adams \$50,000 to purchase the T-shirt business's name and assets.

Answers to this Self-Check are provided at the end of the chapter.

LO 1-5 **SOURCES AND LEVELS OF AMERICAN LAW**

American law is composed of a unique blend from various sources based on U.S. historical roots. Fundamentally, much of American law is derived from English legal doctrines that came with the English settlers of the colonies. In the West and Southwest, land once controlled by Mexico, there are strong Spanish influences, while in Louisiana, once French territory, French civil law roots are evident. Modern law in the United States regulating businesses and individuals is generally a combination of **constitutional law**, **statutory law**, **common law**, and **administrative (regulatory) law** at the federal, state, and local levels. These sources of law are known as *primary sources* of law and may sometimes work in conjunction with one another or independently. For example, law related to the protection of trade secrets⁴ is composed from a variety of sources of law. Perhaps the most famous and profitable example of a trade secret is the recipe and process for making Coca-Cola. While most states have specific trade secret statutes that give legal recourse to a party who has suffered a loss as a result of the unlawful use of trade secrets, some do not. Does this mean that the company that owns the Coca-Cola recipe has no legal recourse against someone who steals its trade secret in those states where no *specific statutes* exist? The answer is no because even absent a specific statute, the law still provides the damaged party some recourse against the violator. This recourse is provided court case history (called *common law*, discussed later) that provides guidance to the trial courts deciding trade secret disputes. Even in states that *do* have statutes related to trade secret protection, there is case law that helps courts apply the statute consistently.

Legal Speak >>)

Enumerated Powers Article I, Section 8, of the U.S. Constitution names 17 specific powers granted to the federal government. These are known as *enumerated powers*.

Constitutional Law

Constitutional law is the foundation for all other law in the United States and is the supreme law of the land. It functions in tandem with other sources of law in three broad areas: (1) establishing a *structure* for federal and state governments (including qualifications of certain offices and positions), setting rules for amending the constitution, and granting specific *enumerated powers* to the different branches of government; (2) establishing the concept of *federalism*, allowing the federal and state governments shared powers; and (3) establishing individual *civil rights* and providing *procedural protections* for U.S. citizens from wrongful government actions.

Constitutional law is different from other sources of law primarily in terms of *permanence* and *preemption*. In terms of permanence, a constitution is thought to reflect the basic principles of a particular society and should be amended only in extraordinary cases and only when a majority of its constituents agree over a certain period of time. Preemption in

⁴Trade secret law, which is covered in detail in Chapter 25, "Intellectual Property," is the legal protection of certain confidential business information.

this context means that constitutional law is supreme over all other sources of law such as federal and state statutes, treaties, and common law. The Constitution further grants federal law supremacy over conflicting state law.

Constitutional law exists at both the federal and state levels because each state has its own constitution that is the highest source of law within the state's borders (so long as it is not inconsistent with federal law). States tend to amend their constitutions more frequently than is the case with the U.S. Constitution. Constitutional issues that impact businesses include Congress's powers to regulate interstate commerce; creation of legal protections for intellectual property (such as patents and copyrights); protection of certain forms of commercial speech from unwarranted government regulation; limitations on a state's authority to tax products and services in commerce; and powers of the executive, legislative, and judicial branches to regulate business activity.

In Case 1.1, the U.S. Supreme Court resolves a conflict between federal and state law by applying constitutional preemption. Preemption and other aspects of constitutional law are discussed in detail in Chapter 2, "Business and the Constitution."

Statutory Law

Statutes are written laws that are passed by the federal or a state legislature and are either approved or rejected by the executive branch. The U.S. Congress is the exclusive legislative body for the passage of federal law. When Congress is drafting a federal statute, but has not yet passed it or had the executive's concurrence, it is known as a *bill*. On the *federal level*, the president is the executive and may sign a bill into law (thereby adopting it as a statute), or the president may veto (reject) the bill subject to the Congress's right to override the veto and make the bill into a statute with a two-thirds majority vote.

At the *state level*, the state legislature (called by different names in different states, such as the *General Assembly*) passes statutes that regulate such areas as motor vehicle laws, business corporation and partnership laws, and other traditional state matters. The governor (as executive) has authority to sign a state bill into law or to exercise other rights as laid out in the state constitution. Written laws at the *local level* are called **ordinances** (sometimes referred to as *local regulations*). Ordinances generally regulate issues such as zoning (regulating where certain businesses, such as factories, may be located) or impose health and safety regulations on local merchants such as restaurants.

Interpreting Statutes When interpreting statutes, courts initially apply the **plain meaning rule**. This means that if the words in the statute have clear and widely understood meanings, the court applies the statute in accordance with the rule. However, more complex statutes require further analysis, and courts look to two sources for guidance. The structure of the statute itself generally provides some indication of how the legislature intended it to be applied. The structure of the statute and the format of its mandates in a law are referred to as its **statutory scheme**. When interpreting statutes, courts also look to the records kept by the legislature, including the debates, committee and conference reports, and legislative findings of fact. These records are known as the statute's **legislative history** and may provide some indication of the intent of the legislative body that passed the statute. For example, in Chapter 2, "Business and the Constitution," we discuss the U.S.



Visit Connect to see an example of
(1) a federal statute (Employment Discrimination),
(2) a state statute (Pennsylvania Business Corporation Law), and (3) a local zoning ordinance.

KEY POINT

Clear and unambiguous language does not mean that everyone who reads the statute will understand it perfectly. For example, the Internal Revenue Code is a federal statute that to the average person may be extremely confusing; however, it makes sense to a person with a background in accounting.

FACT SUMMARY In 2010, the State of Arizona passed the Support Our Law Enforcement and Safe Neighborhoods Act to address problems that the legislature contended were being created by the large number of unlawful immigrants living and working within the state’s borders. Among other provisions, the law created state immigration offenses and expanded the authority of local police to enforce immigration laws by requiring that individuals who were lawfully detained by the police (e.g., a traffic stop) verify their citizenship. The law also provided criminal penalties for unauthorized aliens who sought or engaged in work within Arizona. The U.S. Department of Justice filed suit against Arizona seeking to invalidate the law on the basis that federal immigration statutes precluded individual states from enacting their own immigration laws. Arizona argued that weak and uneven enforcement of federal immigration laws necessitated state regulation and that the state law did not conflict with the federal law. The U.S. court of appeals ruled in favor of the United States, and the state of Arizona appealed to the U.S. Supreme Court.

SYNOPSIS OF DECISION AND OPINION The U.S. Supreme Court struck down the Arizona statute as unconstitutional. The Court ruled that the Arizona statute conflicted with the existing federal law and therefore the state statute is preempted and constitutionally unenforceable. The Court reasoned that (1) immigration is a matter within the purview of the federal government and (2) when the federal government creates rules and sanctions with a clear intent to preclude state action, courts will not enforce any state action that conflicts with established federal mandates.

WORDS OF THE COURT: Preemption of a State Statute “Federalism, central to the constitutional

design, adopts the principle that both the National and State Governments have elements of sovereignty the other is bound to respect. The Supremacy Clause provides a clear rule that federal law ‘shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.’ Art. VI, cl. 2. Under this principle, Congress has the power to preempt state law. . . . State law must also give way to federal law in at least two other circumstances. First, States are precluded from regulating conduct in a field that Congress has determined must be regulated by its exclusive governance. Intent can be inferred from a framework of regulation ‘so pervasive . . . that Congress left no room for the States to supplement it’ or where a federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject. Second, state laws are preempted when they conflict with federal law, including when they stand ‘as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.’”

Case Questions

1. If a federal law or policy is perceived as weak or ineffective, should a state have the right to legislate in that area without federal intervention?
2. Arizona’s law affected Arizona alone and was designed to help Arizona citizens regarding, among other issues, increased employment and reduction of crime. At what point should the federal government have the right to challenge such a state law?
3. Since a challenge based on preemption was known to be an issue from the onset of this statute’s consideration, how might Arizona have better approached the solutions to its illegal immigration problem?

Supreme Court’s ruling on the constitutionality of the Patient Protection and Affordable Care Act (commonly referred to as “Obamacare”).⁵ The act includes an individual mandate requiring individuals to be covered by health insurance by a certain date or face a penalty. The court analyzed the application of the mandate from multiple points of view and, using the act’s statutory scheme and legislative history, it validated the individual mandate’s constitutionality based on its application as a tax rather than as a penalty.

⁵26 U.S.C. § 5000A.

Finding Statutory Law The official publication of federal statutory law is the United States Code (U.S.C.), which arranges all existing federal laws in a system organized by title and divided into chapters and sections. The legal community uses a special format, known as a **citation**, to express where a statutory law can be found. You'll note citations in the footnotes of each chapter of this text that identify a specific reference for the statutes being covered in the chapter. For example, later in this textbook, students will study a federal law called the Fair Labor Standards Act (also known, in part, as the "minimum wage" law) in detail. The citation for the law (listed in the footnote) is 29 U.S.C. § 201. This indicates that in order to find the Fair Labor Standards Act, we need to consult Title 29 of the United States Code and turn to section (abbreviated § in singular or §§ in plural) 201 for the first chapter of the statute. Although attorneys and judges often use specialized software and legal research services to find and understand statutes, an increasing amount of information about statutory resources and statutes themselves is available online for free. Note also that Appendix to Chapter 1 ("A Business Student's Guide to Understanding Cases and Finding the Law") provides information on using the Internet to find and apply statutory law.

State statutes have the same fundamental format and purpose as the U.S.C., but the actual term used to refer to state statutes varies from state to state. *Codes* or *consolidated statutes* are two common terms.

Commercial services also sell print and online versions of federal and state statutes in a unique format that includes annotations and short comments used to interpret the statutes correctly. Attorneys use these commercial services in performing legal research important to properly counseling their clients on the law.

Common Law

Common law is essentially law made by the courts. Although lawmaking is primarily the responsibility of state and federal legislatures, courts must fill in the gaps when a controversy arises that is not covered under existing law. Consider, for example, the impact of the Internet on the development of law. Settled laws related to contracts, jurisdiction, trespass, obscenity, and many other areas had to be reconsidered in light of the widespread use of the Internet. Courts had to fill in the gaps to apply existing law to Internet use until the legislature could respond with statutory law aimed at resolving cyber-related disputes.

The U.S. system of common law is deep-seated in British common law that developed over several centuries, beginning around 1066 when the Norman kings established uniform methods for resolving (mostly land) disputes in England. The largest industrialized nations using the common law in some form include the United States, the United Kingdom, Canada, Australia, and generally the former colonies of Britain. Other countries, such as Japan and France, use a *civil law* system that requires courts to adhere to a strict interpretation of a legislatively established code or regulation. While the general notion of precedent is recognized



The U.S. Congress is the exclusive legislative body for the passage of federal law.



Henry II established English common law courts, called “King’s Bench” courts, around 1178.

Legal Speak >>

Appellate Courts
Courts that review the decisions of trial courts and have the authority to overturn decisions if they are inconsistent with the current state of the law. Trial courts, appellate courts, and other types of dispute resolution forums are covered in detail in Chapter 3, “The American Judicial System, Jurisdiction, and Venue.”

nothing requires their adherence to the foreign states’ decisions. Note that the court system and how appellate courts form precedent is covered in detail in Chapter 3, “The American Judicial System, Jurisdiction, and Venue.”

Stare Decisis and Business

To understand the importance of stare decisis in the business environment, consider the opportunities for business planning that may benefit the company by understanding the legal impact of a certain course of action. Suppose that Jackson is a manager in charge of managing the acquisition of certain assets from another company. One important aspect of such a transaction is how the acquisition will be *taxed*. If Jackson’s company enters into an agreement with Main Street Industries (MSI) to acquire certain assets from MSI, how will the transaction be treated by the Internal Revenue Service (IRS)?⁶ This, of course, is a very important fact in determining the price of the transaction and planning for allocation of the tax burden between buyer and seller. How can the parties structure the transaction to be sure that the taxation represents the parties’ intent? Ultimately, because stare decisis is a deeply rooted concept that applies to all laws, Jackson need only learn how the IRS has treated similar transactions in the past and how courts have ruled on the IRS’s interpretation and actions in applying the law. If a certain transaction has been taxed in a certain way

⁶The IRS is the federal government’s tax agency.

by civil law, its role is substantially reduced in a civil law system. The power of courts to establish law in matters not specifically addressed by the code is very limited in civil law countries. Legal systems and sources of law of foreign countries are covered in Chapter 26, “International Law and Global Commerce.”

Stare Decisis and Precedent LO 1-6

The common law also includes the application of past judicial decisions to contemporary cases. The **doctrine of stare decisis**, one of the most important concepts in American law, is the principle that similar cases with similar facts and issues should have the same judicial outcome. This allows individuals and businesses to have some degree of confidence that the law will remain reasonably constant from year to year and court to court.

The notion of applying the law of previous cases to current cases with substantially similar circumstances is called **precedent**. Precedent is created when an appellate court renders a decision, known as the *holding* of the case, absent a controlling statute. Should a similar fact situation later occur, all *lower courts*, such as trial courts, are bound to follow the appellate court’s decision as long as no new statutory law has been enacted. This provides an element of predictability for lawyers and litigants when they are contemplating legal and business decisions and actions.

When state law is examined, there is nothing common about the common law. Precedent established in one state’s court will have no bearing on the courts of other states. A state court facing a case of first impression might look to precedent created in other states for insight; however,

in the past, the doctrine of *stare decisis* dictates that if Jackson structures her transaction in a similar fashion, her transaction will be taxed in the same way. With sufficient legal certainty about the taxation impact, the parties may now proceed with negotiations and structure a mutually acceptable agreement. However, strict adherence to precedent and the doctrine of *stare decisis* has a significant drawback: It doesn't allow for evolving societal standards of behavior or expectations. On a case-by-case basis, courts sometimes justify departing from precedent on the basis that technological or societal changes render a particular precedent unworkable. In Landmark Case 1.2, a state appellate court considered the question of when to abandon standing precedent.

Administrative Law

While statutory law stems from the authority of the legislature and common law is derived from the courts, administrative law is the source of law that authorizes the exercise of authority by *executive branch* agencies and *independent* government agencies. Members of the House and Senate can't be experts on all things and can't be expected to research the details of all matters before Congress. For efficiency, Congress creates administrative agencies to focus on particular areas, much like a large company creates departments and committees to streamline decision making. Federal administrative law is largely authorized by statutes and the Constitution, and rules for applying the law are articulated and carried out by *administrative agencies*. Pursuant to congressional mandates, these agencies are empowered to administer the details of federal statutes and have broad powers to impose regulations, make policy, and enforce the law in their designated area of jurisdiction. State legislatures also are empowered to create administrative agencies to address state matters. For example, the U.S. Environmental Protection Agency (EPA) is charged with drafting regulations that carry out the broad mandates set by Congress in the Clean Air Act (among many others) to reduce air pollution. The EPA sets regulations and imposes restrictions on some industries to help accomplish that goal. The EPA is also empowered to enforce those regulations. Courts are highly deferential to agency decisions involving how and when an agency enforces a regulation. Detailed coverage of this source of law and administrative agencies is featured in Chapter 18, "Administrative Law."

Some of the specific types of laws that impact business owners and managers and are covered in this textbook are featured in Table 1.2.

TABLE 1.2 Laws That Impact Business

Type of Law	Source(s)	Level(s)
Negligence (tort)	Statutory and common law	Primarily state
Employment discrimination	Primarily statutory and administrative	Primarily state and federal, some local
Copyright	Statutory and administrative	Federal
Contracts for sale of goods	Statutory	State
Contracts for services	Primarily common law	State
Bankruptcy	Statutory and administrative	Federal
Securities law (selling company stock to the public)	Statutory and administrative	Federal and state
Zoning ordinances	Statutory	Local
Taxes	Statutory and administrative	Federal, state, and local

FACT SUMMARY Flagiello, a patient at Pennsylvania Hospital, sued the hospital, claiming it was negligent in maintaining certain conditions on hospital property that resulted in her injuring her ankle. The ankle injury was unrelated to the original reason for Flagiello’s admission to the hospital. A Pennsylvania state trial court dismissed the lawsuit without trial because established state common law clearly exempted charitable institutions, such as the Pennsylvania Hospital, from any liability related to their negligence (a concept called the *charitable immunity doctrine*). Flagiello appealed on the basis that (1) she was a paying patient and (2) the charitable immunity doctrine was outdated given the fact that most charity hospitals now received funding from state and local governments.

SYNOPSIS OF DECISION AND OPINION The Pennsylvania Supreme Court ruled in favor of Flagiello. Although the court acknowledged the important role of stare decisis, it also pointed out that the doctrine is not intended to apply when societal norms dictate otherwise. In this case, the court noted that other states had abandoned the charitable immunity doctrine as no longer necessary and that public benefit and fairness demanded that injured parties who are entitled to recover for their losses be allowed to pursue a negligence action against a charitable institution.

WORDS OF THE COURT: Limits of Stare Decisis “Stare decisis channels the law. It erects lighthouses and [flies] the signals of safety. The ships of jurisprudence must follow that well-defined channel which, over the years, has been proved to be secure and trustworthy. But it would not comport with wisdom to insist that, should shoals rise in a heretofore safe course and rocks emerge to encumber the passage, the ship should nonetheless pursue the original course, merely because it presented no hazard in the past. The principle of stare decisis does not demand that we follow precedents which shipwreck justice.

“Stare decisis is not an iron mold into which every utterance by a court, regardless of circumstances, parties, economic barometer and sociological climate, must be poured, and, where, like wet concrete, it must acquire an unyielding rigidity which nothing later can change.”

Case Questions

1. If Flagiello had been a burglar who was breaking into the medical supply cabinet instead of a patient when she injured her ankle, would the court have been willing to abandon the charitable immunity doctrine? Why or why not?
2. Does this case mean that stare decisis may be discarded whenever a judge perceives that following precedent will “shipwreck justice”?

Legal Speak>>)

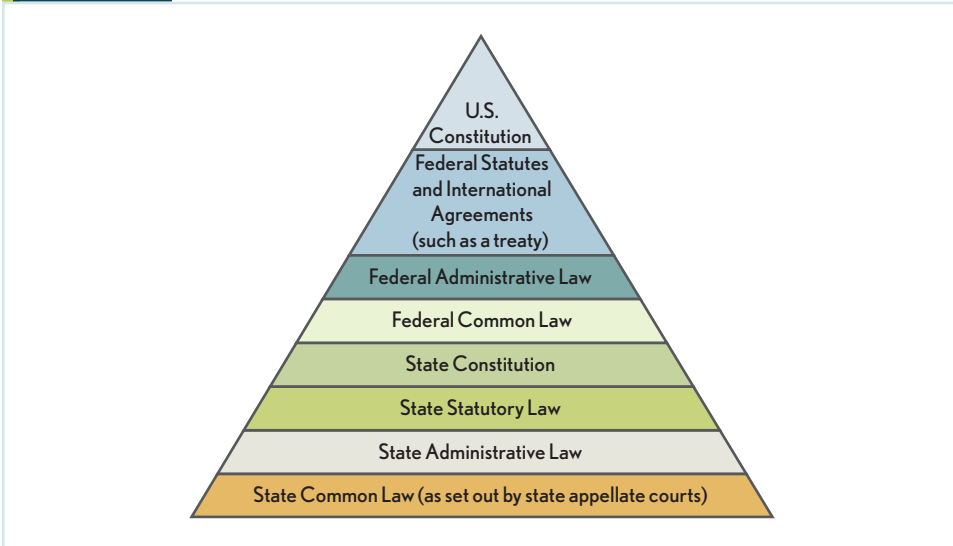
Case of First Impression A case with issues that have never been litigated before in the court hearing it.

Primary sources of law are applied consistent with a hierarchy in which one source may trump another source if the two sources conflict. This is preemption. For example, think about where you’re seated at this moment. What law applies to you? You’re subject to the U.S. Constitution, U.S. treaties, federal statutory and administrative law, and federal common law. You’re also in a state, so state constitutional, statutory, administrative, and common law apply to you. County, city, township, and other local laws might also apply. There is certainly a potential for conflict. Figure 1.1 illustrates the hierarchy of primary sources of federal and state law.

LO 1-5 SECONDARY SOURCES OF LAW

When interpreting statutory law or applying judicially created law, courts also look to **secondary sources** of law. In the business context, the most important secondary sources of law are (1) the *Restatements of the Law*, a collection of uniform legal principles focused in a particular area of traditional state law, and (2) various sets of **model state statutes** drafted by legal experts as a model for state legislatures to adopt in their individual jurisdictions. The purpose behind these secondary sources of law is to increase the level of uniformity and fairness across courts in all 50 states. The secondary sources of law also feature commentary and examples to help guide courts in applying the law. However, secondary sources of law have *no independent authority* or legally binding

FIGURE 1.1 Hierarchy of Primary Sources of Federal and State Law



effect. State legislatures and courts are free to adopt all, adopt part of, or reject secondary sources of law.

Uniform Model Laws

In 1892, the National Conference of Commissioners on Uniform State Laws (NCCUSL) was formed by the American Bar Association for the purpose of establishing uniform standards in areas of the law where national interests would be achieved through use of uniform laws. Imagine that a business in Delaware purchases goods from a seller in New York. While these goods are being shipped by truck on an independent trucking company, they are destroyed in an accident in New Jersey. Which state's law applies? Without a uniform set of laws, businesses would be required to know and apply the law in all 50 states and would be overwhelmed by excessive litigation. Uniform laws solve many of such problems.

The primary focus of the model laws was commerce, and the NCCUSL drafted the Uniform Commercial Code (UCC), which has been adopted in some form by every state except Louisiana. The UCC provides a comprehensive set of rules and principles intended to increase reliability and predictability in business transactions. Although this textbook refers to several different sections of the UCC, extensive coverage is given to Article 2 of the UCC, which governs contracts for the sale of goods. The NCCUSL also created several uniform codes related to the formation and structure of business entities, such as the Uniform Partnership Act and the Model Business Corporation Act. The NCCUSL will from time to time revise these model acts, and the new model laws are referred to, for example, as the *Revised* Uniform Partnership Act.

Restatements of the Law

In the 1920s, the American Law Institute (ALI) was formed to reduce the undue complexity and growing uncertainty of judicial decisions by systematically publishing a *statement* of common law legal principles and rules in a given area of the law, such as torts. The ALI is composed of law professors, judges, and lawyers, and they developed the *Restatements of the Law* in various legal categories. Explanatory notes and applicable examples accompany the Restatements. Restatements are continuously revised, and when the ALI publishes a revision, the new version is referred to by the name and edition; thus, the

second edition of the contracts Restatements is called *Restatements (Second) of Contracts*. The areas covered by the Restatements that are included in this textbook are contracts, property, agency, torts, and foreign relations law.

CONCEPT SUMMARY Sources of Law

Primary:

- Primary sources of law include constitutional law, statutory law, administrative law, and common law at both the federal and state levels.
- Constitutions have two primary functions: (1) to prescribe the basic structure and powers of a particular government body and (2) to protect certain rights of individuals and businesses from government encroachment.
- Statutory law is created by a legislative body and approved or disapproved by the executive branch.
- When interpreting statutes, courts often look to two sources for guidance: (1) the structure of the statute itself, called the *statutory scheme*, and (2) the records of the legislative history behind the statute.
- The official publication of federal statutory law is the United States Code (U.S.C.).
- Common law is law made by appellate courts and is based on the fundamentals of previous cases that had similar facts.
- Appellate courts create precedent, and under the doctrine of *stare decisis*, lower courts apply the precedent to new cases with similar facts.
- Precedent created in a state applies only in that state and has no binding authority in any other state.
- Administrative law is the source of law that regulates the exercise of authority by administrative agencies.
- Pursuant to congressional mandates, administrative agencies are empowered to administer the details of federal statutes and have broad powers to impose regulations, make policy, and enforce the law in their designated area of jurisdiction.

Secondary:

- Secondary sources of law include the *Restatements of the Law* and sets of model statutes such as the Uniform Commercial Code (UCC).
- Secondary sources have no independent authority, nor are they legally binding.
- The *Restatements of the Law* are collections of uniform legal principles in a specific area of law that are designed to reduce the complexity of judicial decisions.
- Model statutes are drafted by legal experts, in hopes that they will be used or adopted by state legislatures so as to provide uniformity in laws between the states.

Self-Check Sources of Law

What is/are the source(s) and level(s) of law that govern the following business transactions?

1. American Hardware Supply enters into an agreement with a retail home improvement chain to supply the chain with certain inventory.
2. Whitney wishes to apply for a patent for a device he invented.
3. Marshall is considering raising money for his business by selling stock in the company.

4. Bio-Tech Inc. ran out of cash and cannot pay its debts as they come due. Management seeks protection from creditors.
5. Barnum wishes to bring his famous horse show into town and plans to stage it in a residential area of the city.

Answers to this Self-Check are provided at the end of the chapter.

CATEGORIES OF LAW

LO 1-7

Because the body of American law is so vast and diverse, it is sometimes helpful to break down the law into broad categories based on classifications related to a particular legal function or a right afforded by law. It is important to note that these classifications are not mutually exclusive. One particular act or transaction may be classified in more than one legal category. For example, suppose that a party to a contract breaks her promise to the other party (an act known as a *breach of contract*). The remedy for the breach may depend on the legal classification of contracts as *civil law*. At the same time, one party may have rights classified as *substantive law*, which are derived from a source of *statutory law*.

Criminal Law versus Civil Law

Laws, primarily statutes, are either *criminal* or *civil* in nature. **Civil laws** are designed to compensate parties (including businesses) for losses as a result of another's conduct. These losses are known as **damages**. **Criminal laws** are a protection of society, and the violation of criminal laws results in penalties to the violator such as fines or imprisonment. Criminal fines are paid to the government and do not reimburse the victim. Remember that these categories are not mutually exclusive. For instance, a driver who is intoxicated and injures a pedestrian in an accident has committed both a criminal act (driving while intoxicated), for which he can be prosecuted by authorities, and a civil wrong (negligence), for which the driver can be sued by the injured party to recover for any losses suffered as a result of the injury (medical bills, etc.). Criminal law as it relates to business will be discussed in Chapter 23, "Criminal Law and Procedure in Business."

Substantive Law versus Procedural Law

Substantive laws provide individuals with rights and create certain duties. **Procedural laws** provide a structure and set out rules for pursuing substantive rights. For example, while state common law may provide an individual who has suffered losses due to the negligence of another the right to obtain restitution from the wrongdoer (substantive law), a state statute will prescribe the procedure for using legal means to actually collect the restitution (procedural law). This includes rules that govern court procedures such as how and when to file a lawsuit as well as the process for obtaining the restitution once a court has given the injured party a certain money award. Procedural law also sets out the steps the government must take if it needs to infringe on substantive rights. For example, if the police believe that a business owner is committing a nonviolent crime such as embezzlement or fraud, they may not simply barge into the owner's office without notice to search for and seize evidence. The Fourth Amendment to the U.S. Constitution protects citizens against unreasonable searches and seizures, a substantive right of privacy. The Fourth Amendment also specifies the procedural steps that must be taken to override the substantive rights in question in order to obtain a search warrant. These steps require that the police convince a judge or magistrate, through evidence of probable cause, that a crime is being committed and evidence necessary to prove that crime is in the owner's possession.

LO 1-8 Law versus Equity

Most modern American courts are combined courts of law and equity. However, we still use the terms *law* and *equity* when describing the appropriate *measure of judicial action* intended to compensate an injured party in a civil lawsuit. These measures are known as **remedies**.

Remedies at law generally take the form of *money damages*: A court orders the wrongdoer to pay another party a certain sum of money to compensate for any losses suffered as a result of the wrongdoer's conduct. However, in some cases, a party will not necessarily be fully or even partially compensated through money damages. In such a case, a court may award **equitable relief** instead of (or in addition to) a remedy at law. Most

KEY POINT

When a remedy at law is inadequate, an injured party may also obtain a remedy at equity. When a remedy at law is fully sufficient to bring justice, equitable remedies are not permitted.

commonly, equitable relief can include an *injunction* or *restraining order* (a judicial order requiring a party to either perform or cease a certain activity) and *specific performance* (an order requiring a party to carry out her obligations as specified in a contract). Specific performance is available only if the goods contracted for are rare or one of a kind. To understand this concept in a business context, suppose that Maxwell enters into a

valid written agreement with Book Barn to purchase a first edition of *The Old Man and the Sea*, autographed by Ernest Hemingway, for \$25,000. Maxwell leaves the store to obtain a certified check from his bank. When he returns one hour later, the owner of Book Barn refuses to sell him the book because he had received a phone call from another buyer offering \$30,000. In this case, Maxwell may file a lawsuit for Book Barn's failure to live up to the agreement (known as *breach of contract*, discussed in Chapter 8, "Contract Performance: Conditions, Breach, and Remedies"), but he has not suffered an out-of-pocket loss because he never had the opportunity to present Book Barn with the check. However, Maxwell could seek a *remedy at equity* from a court, where he would request an injunction to prevent Book Barn from selling the book to another buyer until the court can hear the case. If Maxwell wins the case, he may seek an order of *specific performance* whereby the court orders Book Barn to transfer ownership of the book to Maxwell in exchange for the \$25,000 price as specified in the agreement between the parties. Maxwell would likely be awarded these equitable remedies because the legal remedies available to him are not adequate to address his injury.

LO 1-9

The term *equity* is also used in the context of common law rules that guide courts in deciding cases and controversies before them. These equity rules are called **equitable maxims** and are intended to be broad statements of rules that are based on notions of fairness and justice in applying the law. The most commonly applied maxims are "Equity aids the vigilant," "substance over form," and the "clean hands doctrine." These doctrines are frequently applied in suits seeking both legal and equitable damages.

- *Equity aids the vigilant*: Perhaps the most universal of the maxims is the notion that the law favors those who exercise *vigilance* in pursuing their claims and disfavors those who rest on their legal rights by failing to act to protect their rights in a reasonable period of time. If company A develops new technology, obtains a patent, and soon sees company B infringing on its patent by using that same technology, company A would be successful in obtaining an injunction stopping company B. If, instead, company A waits for company B to go into worldwide production and establish extensive retail partnerships and then sues for injunctive relief years later, the courts would be reluctant to assess punishment and could possibly void the patent protection entirely. A statute of limitations, discussed in Chapter 4, "Resolving Disputes: Litigation and Alternative Dispute Resolution Options," is a formal application of this doctrine.
- *Substance over form*: When applying the law, courts look to the intent of parties involved and adhere to a standard of good faith and fair play instead of applying the

letter of the law in a way that would violate fundamental principles of fairness and consistency. In 1992, 8,000 workers sued Microsoft, claiming that they were not being paid benefits owed. Microsoft had hired them through temporary staffing firms and classified them as temporary workers, ineligible for full company benefits. The court determined that these workers, many of whom were employed for more than a year, worked the same hours and performed the same functions as the company's permanent workers. Even though Microsoft had these workers sign agreements stating that they were not regular employees of Microsoft, the court found that despite the label and classification, they were indeed permanent workers entitled to benefits. Microsoft eventually agreed to pay \$97 million to settle the claims.⁷

- **Clean hands doctrine:** Commentators sometimes describe loopholes in the law as responsible for creating injustice and protecting wrongdoers. However, more often than not, courts are not inclined to decide disputes based on technicalities that benefited a party who acted dishonestly. Courts are guided in their decisions not only by the letter of the law but also on the basis that one seeking the aid of a court must come to the court with clean hands that are unstained by bad faith, misrepresentations, or deceit. In Case 1.3, a state appellate court applies the clean hands doctrine.

Public Law versus Private Law

Public laws are those derived from some government entity. Examples include statutes (legislature/executive) and administrative regulations (state or federal administrative agencies).

Private laws are recognized as binding between two parties even though no specific statute or regulation provides for the rights of the parties. The most common example is a contract for services. For example, suppose Claude hires Pablo to paint a portrait of Claude's wife. After it is complete, Claude thinks Pablo's painting is too abstract and refuses to pay for it. Although no specific public law exists that regulates this relationship, the agreement is still legally binding and the rules of the transaction are governed by the common law of contracts.

CASE 1.3 Kauffman-Harmon v. Kauffman, 36 P.3d 408 (Sup. Ct. Mont. 2001)

FACT SUMMARY Kauffman created a corporation to hold certain assets in a manner intended to minimize tax liability. After creation of the corporation, a judgment was entered against Kauffman as a result of a lawsuit against him. In order to avoid paying the judgment, Kauffman transferred all of his stock into his spouse's name. His spouse eventually transferred ownership of the stock to several Kauffman children. Several years later, a dispute developed between the children concerning the stock, and Kauffman intervened by filing a claim with the trial court requesting that all stock be transferred back to him on the basis that he was the rightful owner of the stock and that the transfer was nothing more than a temporary trust. The children contended that Kauffman is not the equitable owner of the stock and is not entitled to relief due to the clean hands doctrine.

SYNOPSIS OF DECISION AND OPINION The Supreme Court of Montana ruled in favor of the Kauffman children, holding that Kauffman was not entitled to relief. Because Kauffman's transfer perpetrated an exchange of stock only to avoid paying the judgment legally entered against him, the transaction was a bad-faith action that bordered on a fraudulent transaction. The court reasoned that the rightful owner of the stock was the Kauffman children and that Kauffman's claims were barred by the clean hands doctrine. The court concluded that recognizing his claim would result in a gross wrong being done to the children and the shareholders of the corporation.

WORDS OF THE COURT: Clean Hands Doctrine "The doctrine of clean hands provides that parties must not expect relief in equity, unless they come into court

(continued)

⁷*Vizcaino v. Microsoft*, 120 F.3d 1006 (9th Cir. 1997), cert. denied, 118 S. Ct. 899 (1998).

with clean hands. . . . Thus, no one can take advantage of his own wrong. . . . Court[s] will not aid a party whose claim had its inception in the party's wrongdoing whether the victim of the wrongdoing is the other party or a third party."

Case Questions

1. Would the court's ruling be the same if the children had also participated in the transactions and were accused of wrongdoing? Why or why not?
2. Given the court's reasoning, would the result of this case be the same if the transfer of stock was for a legitimate purpose and the only wrongdoing Kauffman had committed involved a third party in an unrelated matter? Why or why not?



SOLUTIONS FOR MANAGERS

Legal Decisions in Business: An Analytical Model

PROBLEM *Legal decision making by managers is reactionary, uneven, and sometimes uninformed.*

SOLUTION *Use a systematic analytical model designed to identify legal issues, and understand those issues as business planning opportunities that enable the management team to add value to the company.*

Understanding the theories and applications of law in a business context is important to meeting legal challenges, but incorporating this knowledge via the use of an analytical model helps to convert legal challenges into astute business planning and potential opportunities. This model may be used for any legal challenge, but a fundamental understanding of applicable legal doctrines and applications is necessary to take full advantage of its use. Keep this model in mind while you are studying the material in this textbook. You'll find that it will become more valuable as your knowledge of substantive law increases. When confronted with a legal challenge, managers with a high level of legal awareness should follow a seven step model: *Identify* → *Assess* → *Analyze* → *Examine Alternatives* → *Compare* with business mission, objectives, and ethical considerations → *Implement, monitor, and revise* → *Review* for business planning opportunities.

Step 1: *Identify potential legal issues.* One of the objectives of this textbook is to provide students with essential legal doctrines and examples of how the law impacts business operations and planning.

Legal awareness is the primary tool for identifying legal issues and responding appropriately. Businesses should be both proactive and reactive in identifying potential legal issues. Proactive measures include having apparatus in place that limits liability exposures (such as standardized hiring and promotion procedures), while reactive measures require that business owners and managers follow a legally sound course of action once they become aware of a potential legal issue.

Step 2: *Assess the imminence and level of any legal challenge and decide whether to confer with counsel.* While legally adept managers have the ultimate goal of understanding legal challenges as potential planning opportunities, the primary consideration when confronted with a legal challenge is to assess how much potential liability may be involved and to understand the posture of the parties. For example, if a manager of a wholesaling company receives a complaint from a customer about the quality of goods purchased, that is a legal challenge (essentially an allegation of breaking a contract) with potential for litigation in the future, but the level and immediacy of the threat is low. The matter may be worked out amicably, ethically, and legally without counsel. If, during negotiations, the customer begins to indicate that he will be pursuing legal alternatives, the threat level has increased and counsel should be consulted immediately. Although there is no need for counsel to intervene at this point, she should be briefed on the matter in the event that the customer takes more

formal action. On the other hand, if a company manager receives a complaint from an employee about being sexually harassed by her co-workers, the *potential* threat is high and it is an imminent threat because the business's liability will continue to accrue rapidly unless immediate action is taken. The costs of this type of legal challenge may be very high, and alternatives become more limited. Thus, counsel should be consulted immediately.

Step 3: *Analyze the legal implications of the legal challenge using the worst-case scenario and include an estimate of costs including legal fees and court costs, a losing judgment, and potential draws on human resources required to meet the challenge.* Using the worst-case scenario gives a manager context, which is helpful to understanding the potential liability faced because of the legal challenge. For example, if a customer is threatening to sue his supplier for breach of contract based on a \$50,000 loss that he suffered, the worst-case scenario for the *supplier* is that the case goes to trial and the customer wins the judgment. Thus, the expenditure is \$50,000 plus legal fees (which vary greatly from case to case and from attorney to attorney, but one could reasonably expect the legal fees and costs to be \$25,000 to \$100,000 based on the complexity of the case), plus the time and expenses that will be required for officers and employees to participate in the pretrial and trial process. An appeal will be even more costly. The scenario essentially sets the baseline for what a certain course of action could cost the company.

Step 4: *Evaluate alternatives by developing a list of various approaches that could be used to meet the legal challenge. While considering advantages and disadvantages of alternatives, estimate the costs and potential return on expenditures made to meet the legal challenge.* Once a baseline potential for costs has been set, a variety of approaches should be considered. However, it is important that each approach also be subjected to a *cost-benefit analysis* (e.g., what will it cost to invest in this approach, and what benefit will the business reap through the investment?). For example, suppose that TechCo enters into a contract with Big Insurance Company (BIC) to provide installation and maintenance of BIC's computer network based on "industry standards."

After the installation, BIC is unhappy with the work and threatens to sue TechCo on the basis that its work was below industry standards and therefore violates the terms of their agreement. BIC demands that TechCo rewire its entire office (which will cost TechCo \$60,000) or it will file a lawsuit. When examining alternatives, TechCo managers will almost certainly consider aggressive litigation as one approach. TechCo could simply refuse to act any further, wait for the lawsuit to be filed, and then hire a law firm that promises to be hard-nosed and refuses to concede even the smallest point or to entertain any settlement offers. If indeed TechCo is within its legal rights to refuse BIC's demand, it will emerge from the trial victorious. However, the cost-benefit analysis is more problematic. Even if TechCo wins, the legal fees⁸ for pretrial activities, trial work, and a possible appeal may very well end up being close to or even exceed the amount in dispute. Add the costs of human resources necessary to support this alternative and the possible damage to TechCo's reputation in the market that is inherent in litigation, and this approach begins to look less attractive. The following table lists alternatives along with sample costs, risks, and benefits to meet TechCo's legal challenge.

Step 5: *Compare the alternatives with the business's mission, objectives, and ethical codes of conduct. Which alternatives are consistent with ethical decision-making standards and any statement of corporate social responsibility?⁹ May any of the alternatives be turned into a business opportunity?* Once various strategies have been tested in terms of cost-benefit and risks, an equally important comparison should be done in the context of the company's mission, objectives, and ethical codes of conduct. If the company has developed certain statements concerning ethics and/or corporate social responsibility,

⁸Note that in the American legal system, the general rule regarding legal fees is that each side bears its own legal fees and costs of litigation. However, some exceptions exist to this general rule, such as when a statute specifically provides that a successful litigant may recover attorneys' fees from the losing party (e.g., employment discrimination statutes).

⁹Business ethics and corporate social responsibility are discussed in detail in Chapter 5, "Business, Societal, and Ethical Contexts of Law."

(continued)

what alternative is most consistent with those statements? In the TechCo-BIC case discussed earlier, suppose that TechCo's internal policies provided that "TechCo believes that each client must be 100 percent satisfied with our services, or we will work at our own expense until the client is fully satisfied." While TechCo has no legal duty to comply with that internal standard, doesn't this maxim help TechCo's management in selecting an approach to legal challenges by its clients? Also, perhaps this dispute can be turned into an opportunity whereby BIC will potentially spread the word in the business community that TechCo is highly committed to customer service rather than to fighting its clients in a courtroom. Even if TechCo does not make a profit on the BIC agreement, isn't the long-term view more compelling?

Step 6: *Implement the chosen alternative and adjust the solution based on your monitoring of the costs, values, and opportunities. Be ready to revise and seek more opportunities as more information about the*

challenge becomes available. Once a course of action has been determined, the model then shifts toward implementation and monitoring. As more information becomes available or as costs rise unexpectedly, it may be necessary to adjust the alternatives to accommodate the new information. For example, assume that in the TechCo-BIC case, the parties agreed on private arbitration.¹⁰ Just before the arbitration, a TechCo internal investigation concludes that one of its installers incorrectly wired a small segment of the BIC network but that the entire network was not corrupted. At this point, given TechCo's business values, its potential for liability, and the costs of arbitration, TechCo may now be willing to enter into a settlement agreement with BIC rather than risk a loss at arbitration. On the other hand, if BIC continues to demand

¹⁰Private arbitration is a nonjudicial method for resolving legal disputes. Its costs tend to be much lower than litigation. Arbitration is discussed in detail in Chapter 4, "Resolving Disputes: Litigation and Alternative Dispute Resolution Options."

Alternative	Costs/Risk/Impact	Benefit to the Corporation
Aggressive litigation	<p>Costs: Monetary—high Human resources—high</p> <p>Risks: (1) Uncertainty about outcome; (2) irreparable client relations; (3) long-term distractions (3–8 yrs); and (4) potential damage to reputation in the marketplace.</p>	Winning the lawsuit will settle the matter (subject to appeal).
Alternative dispute resolution such as arbitration or mediation.	<p>Costs: Monetary—medium Human resources—medium to high</p> <p>Risks: (1) Damage to client relations; (2) potential failure to obtain a satisfactory outcome.</p>	<p>Dispute is settled without costly litigation or (usually) uncertainty of appeal.</p> <p>Potential to repair client relations or reputation in the business community.</p>
Amend existing contract to provide for limited additional services by TechCo that will satisfy the parties (e.g., TechCo will be willing to re-network any computer system exhibiting impaired functionality according to industry standards to a maximum of \$30,000).	<p>Costs: Monetary—low Human resources—medium</p> <p>Risks: Potential that BIC may still not be satisfied and a lawsuit will still be filed.</p>	Potential to repair client relations and/or increase reputation in the business community as a company that is highly committed to quality and customer service.

a total rewiring costing \$60,000, TechCo may opt to take its chances at arbitration.

Step 7: *During monitoring and after the legal challenge has been met, evaluate how the challenge could have been prevented or handled better. Devise a system or process that will help to limit future legal challenges.* While it is natural for managers to move onto other pressing matters after having met a legal challenge, a significant business opportunity may be lost in failing to analyze the dispute with the benefit of hindsight. For example, after resolving the BIC dispute, TechCo could confer with its counsel on possible revisions to future

installation contracts that would clarify which installation standards apply instead of using the term “industry” standards. There may also be an opportunity to revise future contracts to ensure that any lawsuit filed as a result of a dispute related to the agreement takes place close to TechCo’s headquarters. Adding such language (known as a *forum selection clause*) will help contain TechCo’s costs in the event of litigation or arbitration. Other opportunities may include designing a quality control system for future installation, rethinking the company’s risk in that particular market segment, and identifying business planning opportunities unique to TechCo’s industry and practices.

KEY TERMS

Law p. 3 A body of rules of action or conduct prescribed by controlling authority and having legal binding force.

Jurisprudence p. 3 The science and philosophy of law that defines various approaches to the appropriate function of law and how legal doctrines should be developed and applied.

Black’s Law Dictionary p. 5 The leading legal dictionary.

Counsel p. 6 Another term for *attorney*.

Constitutional law p. 8 The body of law interpreting state and federal constitutions.

Statutory law p. 8 The body of law created by the legislature and approved by the executive branch of state and federal government.

Common law p. 8 Law that has not been passed by the legislature but rather is made by the courts and is based on the fundamentals of previous cases with similar facts.

Administrative law p. 8 Refers to both the law made by administrative agencies and the laws and regulations that govern the creation, organization, and operation of administrative agencies.

Ordinances p. 9 Local statutes passed by local legislatures.

Plain meaning rule p. 9 The principle that if the words in a statute have clear and widely understood meanings, the court applies the statute; used as the initial guideline in statutory interpretation to determine how a rule should be applied.

Statutory scheme p. 9 The structure of a statute and the format of its mandates.

Legislative history p. 9 The records kept by the legislature, including the debates, committee and conference reports, and legislative findings of fact used when creating a law, which can be used to show the legislature’s intent.

Citation p. 11 The special format used by the legal community to express where a statute or case law can be found.

Doctrine of stare decisis p. 12 The principle that similar cases with similar facts under similar circumstances should have similar outcomes.

Precedent p. 12 Applying the law made in previous appellate court opinions to current cases with similar facts; binding on the trial courts.

Secondary sources p. 14 Sources of law that have no independent authority or legally binding effect but can be used to illustrate a point or clarify a legal issue.

Restatements of the Law p. 14 A collection of uniform legal principles focused in a particular area of the law, which contains statements of common law legal principles and rules in a given area of law.

Model state statutes p. 14 Statutes drafted by legal experts to be used as a model for state legislatures to adopt in their individual jurisdictions in order to increase the level of uniformity and fairness across courts in all states.

Civil laws p. 17 Laws designed to compensate parties for money lost as a result of another's conduct.

Damages p. 17 Money lost as a result of another's conduct.

Criminal laws p. 17 Laws designed to protect society that result in penalties to the violator such as fines or imprisonment.

Substantive laws p. 17 Laws that provide individuals with rights and create certain duties.

Procedural laws p. 17 Laws that provide a structure and set out rules for pursuing substantive rights.

Remedies p. 18 Judicial actions, which can be monetary or equitable, taken by courts that are intended to compensate an injured party in a civil lawsuit.

Equitable relief p. 18 A type of remedy, including injunctions and restraining orders, that is designed to compensate a party when money alone will not do by instead forcing the other party to do (or not do) something.

Equitable maxims p. 18 Common law rules that guide courts in deciding cases and controversies and are intended to be broad statements of rules based on notions of fairness and justice.

Public laws p. 19 Laws derived from a government entity.

Private laws p. 19 Laws recognized as binding between two parties even though no specific statute or regulation provides for the rights of the parties.

THEORY TO PRACTICE

Galaxy Inc. is a supplier of greeting cards, small gifts, tokens, and games appropriate for special occasions such as holidays and birthdays. Galaxy distributes its products primarily through large supermarket and drugstore chains. Increasingly, Galaxy has lost revenue due to supermarkets that prefer to enter into the supplier market by manufacturing these products in a foreign country at a steep discount (instead of buying Galaxy's products) and selling them in their stores at a higher profit. In response to this, Galaxy's management team begins to roll out a new business model whereby Galaxy will begin to retail its own products through newly created Galaxy retail stores. Jackson is a senior manager charged with overseeing the expansion efforts.

1. Suppose that Jackson intends to lease (rent) these new spaces for the Galaxy stores and hire new employees to staff them. What areas of the law may impact Jackson's planning process?
2. What options does Jackson have for legal advice to guide his efforts? What is the role that counsel might play in these transactions?
3. What sources and levels of law would Jackson need to have a fundamental knowledge of to help him protect his company from liability and meet any legal challenges? Give specific examples.
4. Assume that Jackson also plans to acquire the assets of a smaller retail company in order to carry out this expansion. Jackson is concerned about the potential tax impact that may be triggered by the transaction. How can Jackson plan with certainty for a particular type of tax treatment? What legal doctrine allows him to rely on the law in the planning process?
5. Assume that Jackson enters into a contract with Holmes for Holmes to act as store manager in one location. After two weeks, Jackson fires Holmes for incompetence. Holmes believes that Jackson fired him in violation of an antidiscrimination law, but he keeps forgetting to file the appropriate paperwork and eight months pass by. Finally, Holmes gets around to filing a complaint. What equitable maxim would apply to Holmes's complaint? Does this maxim favor Holmes or Jackson?

Midlevel managers are frequently involved with vendors, competitors, customers, and employees on a daily basis, and this makes them invaluable tools for spotting and meeting legal challenges in the early stages. Suppose that in the Theory to Practice problem, Jackson, a senior manager, receives an e-mail from a competing company:

“Galaxy: You have stolen our trademark. We have the trademark rights for the Hobgoblin Necklace and you don’t have our permission to use it. Yet, on a recent visit to one of your stores, you have Hobgoblin Necklaces for sale. Cease and desist or we will turn this matter over to our attorney.

Signed,
Necklace Emporium

Assume that you are a midlevel manager and that Jackson hands you the e-mail and informs you that, to his knowledge, Galaxy followed all proper legal procedures for the trademark. Using the analytical model presented in Solutions for Managers on page 20, compose a two- to three-page memorandum addressed to Jackson that gives guidance on handling this legal challenge. A sample answer may be found on this textbook’s website at www.mhhe.com/melvinleb2e.

CASE SUMMARY 1.1 :: Sokoloff v. Harriman Estate Development Corp., 754 N.E.2d 184 (N.Y. 2001)

EQUITY AND FAIRNESS

Sokoloff purchased land in the Village of Sands Point and, in anticipation of building a home, hired Harriman to provide preconstruction services, including the creation of architectural and landscaping plans. Sokoloff paid Harriman a \$10,000 retainer fee and a total of \$55,000 for creating and filing the architectural plans with the village. However, when it came time to build the home, Harriman estimated the cost to be over \$1.8 million. Sokoloff, finding this amount to

be exorbitant, decided to get quotes from other builders, based on the plans he had Harriman design. However, Harriman said that the plans could not be used to construct the home unless he was the builder.

CASE QUESTIONS

1. Can Harriman withhold the plans from Sokoloff?
2. What legal theories or maxims would a court consider in deciding this case?
3. How should the court rule and why?

CASE SUMMARY 1.2 :: Jones v. R. R. Donnelley & Sons Co., 541 U.S. 369 (2004)

STATUTE OF LIMITATIONS

The U.S. Congress enacted a statute providing for a four-year statute of limitations for any cause of action arising out of an act of Congress enacted after 1990. Jones, an African-American employee of R. R. Donnelley & Sons Co. (Donnelley), was denied a transfer to one of Donnelley’s other plants when his plant closed. Moreover, while an employee for Donnelley, Jones was subject to a hostile work environment and

various acts of discrimination. Jones, an Illinois citizen, wishes to sue Donnelley for violating federal anti-discrimination statutes. It has been three years since Jones worked for Donnelley, and Illinois has a two-year statute of limitations.

CASE QUESTIONS

1. Which statute of limitation governs and why?
2. Will Jones be able to sue Donnelley?

CLEAN HANDS DOCTRINE

Case Credit Corp. (Case) finances the sale of farm equipment to farmers. Day bought farm equipment financed by Case, yet Day never actually signed the sales contract. Instead, an employee of Case forged Day's signature on the sales contract with higher prices in an effort to pocket the difference for himself. Case was aware of the forgery, but did not make any effort to stop him or inform Day. When Day could not pay the

loans back, Case filed suit to recover the farm equipment or compel payment.

CASE QUESTIONS

1. If the court applies the clean hands doctrine, will Case be able to recover the farm equipment because Day is unable to make the payments? Why or why not?
2. Are Case's hands clean? Why or why not?

EQUITABLE RELIEF

Monfort, the nation's fifth largest beef packer, is concerned about a merger of the nation's second largest packer, Cargill, with the nation's third largest packer. Monfort believes that the merger will give Cargill almost 21 percent of the market, leaving Monfort with only 5 percent. Monfort believes this merger may result

in a violation of federal antitrust laws and wishes to file suit to prevent it.

CASE QUESTION

1. If Monfort files suit and the merger is deemed to violate antitrust laws, what type of remedy will Monfort want to receive and why?

INTERPRETING STATUTES

More than decade before a federal law set a minimum wage for workers, the State of Oklahoma passed a statute that established a minimum wage for workers performing services for the state government. The law based the minimum wage on "the current rate of per diem wages in the locality where the work is to be performed." The state's commissioner of labor charged General Construction with violating the minimum wage law. The commissioner alleged that various workers were being

underpaid. General Construction argued that the statute was too vague to be enforceable.

CASE QUESTIONS

1. Is the language "current rate of wages" certain enough to be enforceable? Why or why not?
2. Is there any other ambiguous or vague language in the statute? How could the statute be reworded in order to overcome any notion of vagueness?

PRECEDENT

This case arises from an assessment of a civil penalty against two landowners for violations of the Sedimentation Pollution Control Act of 1973, the North Carolina Department of Natural Resources and Community Development (NRCD). While enlarging one of the subdivisions on the property, between October and December 1983, the owners disturbed approximately 2½ acres of land by grading, cutting, and filling, in order to construct a street to provide access to residential lots. Owners were assessed civil penalties for violations of the act. The trial court concluded that although the assessment was “not effected [sic] by error of law,” the authority conferred by the statute allowed the secretary of NRCD to assess civil penalties in his “absolute discretion,” and thus the statute constituted a legislative grant of judicial power prohibited by the North Carolina Constitution. A divided panel¹¹ of the North Carolina Court of Appeals upheld

the trial court’s judgment. In doing so, the panel disregarded another panel of the North Carolina Court of Appeals that had, in a previous case with the same issues, found that the NRCD has discretion to assess fines based on its discretion due to guidelines and limitations that exist in the act in question. The North Carolina Supreme Court heard the appeal.

CASE QUESTIONS

1. How is precedent created, and how is it applied in future cases?
2. When two separate panels of the same court hear different cases with similar issues, must the second panel follow the decision made by the first?
3. If precedent has been set by a state appellate panel, who has the power to overrule that precedent?

¹¹Often, appellate court justices do not all sit on cases together. For efficiency, smaller groups, frequently called panels, may hear and decide cases.

✓ Self-Check ANSWERS

Role of Counsel

1. Laws related to start-up (incorporation), sales of goods (commercial law), ordinances such as zoning (basement location), and taxation of transactions and income.
2. *For business operations:* laws related to lease of a kiosk, credit transactions, local licensing.
For employees: labor laws (minimum wage, overtime), employment discrimination.
3. How to qualify for trademark protection, the process of registration, enforcement of the mark.
4. Asset purchases, contracts, taxes, trademarks.

Sources of Law

1. A contract issue governed by statutory (UCC) law at the state level.
 2. A patent issue governed by statutory law at the federal level.
 3. A securities issue governed by statutory and administrative law at the federal and state levels.
 4. A bankruptcy issue governed by statutory and administrative law at the federal level.
 5. A zoning issue governed by statutory law at the local level.
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APPENDIX TO CHAPTER 1

A Business Student's Guide to Understanding Cases and Finding the Law

This textbook emphasizes ways in which business owners and managers can add value to their companies by using legal insight for business planning and limiting risk. Using a basic system for understanding court case opinions improves one's ability to grasp the impact of the law on business. Because much of the law is composed of cases and statutes, learning the fundamentals of how and where to find the law allows business owners and managers to work more effectively with counsel and empowers them to become better decision makers by using legal considerations as a part of their strategic planning.

Understanding Case Law: The SUR System

All of the legal cases in this textbook are reported in a unique format designed especially for business students. For each case, students are provided with a summary of the case facts and a synopsis of the court's decision and opinion. Students then read an actual excerpt from the case in the *words of the court* that is directly related to the legal point being covered in the text. All procedural language and parts of the opinion that are unrelated to the legal point have been edited out. This allows the reader to focus on one or two key points of law in the case. However, case law from other sources is likely to be a complete word-for-word reporting without any trustworthy explanation or summary. Understanding cases by reading the full text can be challenging even for attorneys. The *SUR system* provides business students with a systematic method for analyzing cases that will help draw

out essential information without getting bogged down in legal details.

SUR stands for *scan, understand, review*. Although this system is helpful for reading any complex or dense text, it is specifically tailored for reading legal cases. Not only will this method help students fully understand the cases contained in this text, but it is also useful for comprehending full-length cases found in other sources. Figures 1A.1, 1A.2, and 1A.3 illustrate how the *SUR* system is applied.

Scan the Case

Read the *headings* and *first two sentences* of each section of the case to the end of the opinion. Then read the *last three* sentences of the case. While scanning, use a pencil or highlighter to note names of the parties, the court that decided the case, and the final decision of the court.

Understand the Case

After scanning, begin to read (and reread when necessary) the case from the beginning. Use a pencil to circle important facts and legal terms. At this stage, many students find it useful to draw flowcharts and other summaries in order to understand a chain of facts more clearly. Look up legal terms using the online law dictionary listed in Table 1A.1 later in this appendix. Do your best to skip procedural language such as the standards of review for an appellate court or issues related to pretrial discovery or motions. While reading the fact summary in the beginning of the case, keep the following question in mind:

After the Scan stage, the text would appear as follows:

CASE 1.3 Kauffman-Harmon v. Kauffman, 36 P.3d 408
(Sup. Ct. Mont. 2001)

FACT SUMMARY: Kauffman created a corporation to hold certain assets in a manner intended to minimize tax liability. After creation of the corporation, a judgment was entered against Kauffman as a result of a lawsuit against him. In order to avoid paying the judgment, Kauffman transferred all of his stock into his spouse's name. His spouse eventually transferred ownership of the stock to several Kauffman children. Several years later, a dispute developed between the children concerning the stock, and Kauffman intervened by filing a claim with the trial court requesting that all stock be transferred back to him on the basis that he was the rightful owner of the stock and that the transfer was nothing more than a temporary trust. The children contended that Kauffman is not the equitable owner of the stock and is not entitled to relief due to the clean hands doctrine.

SYNOPSIS OF DECISION AND OPINION: The Supreme Court of Montana ruled in favor of the Kauffman children, holding that Kauffman was not entitled to relief. Because Kauffman's transfer was in perpetrating an exchange of stock only to avoid paying the judgment legally entered against him, the transaction was a bad-faith action that bordered on a fraudulent transaction. The court reasoned that the rightful owner of the stock was the Kauffman children and that Kauffman's claims were barred by the clean hands doctrine. The court concluded that recognizing his claim would result in a gross wrong being done to the children and the shareholders of the corporation.

WORDS OF THE COURT: Clean Hands Doctrine

"The doctrine of clean hands provides that parties must not expect relief in equity, unless they come into court with clean hands. . . . Thus, no one can take advantage of his own wrong. . . . Court[s] will not aid a party whose claim had its inception in the party's wrongdoing whether the victim of the wrongdoing is the other party or a third party."

ISSUE: What legal *issues* are being created by the party's actions? That is, what legal *question* will the court have to answer?

Once you begin reading the court's ruling, continue to mark potentially important phrases, paying special attention to the court's statement of the current law. Look for wording such as "the statute provides for" or "the only relief available under the statute" to alert you to important language. As you read and mark the text,

keep in mind the following questions and jot down any related thoughts:

RULE: What law *generally* applies to this situation, and are there any exceptions? What statute, common law, or other legal doctrine is applicable in this situation? What precedent exists? Courts often start the legal analysis section of their opinions by stating what the law is or by quoting from the statute at issue.

FIGURE 1A.2

After the *Understand* stage, the text would look like this:

CASE 1.3 Kauffman-Harmon v. Kauffman, 36 P.3d 408 (Sup. Ct. Mont. 2001)

FACT SUMMARY: Kauffman created a corporation to hold certain assets in a manner intended to minimize tax liability. After creation of the corporation, a judgment was entered against Kauffman as a result of a lawsuit against him. In order to avoid paying the judgment, Kauffman transferred all of his stock into his spouse's name. His spouse eventually transferred ownership of the stock to several Kauffman children. Several years later, a dispute developed between the children concerning the stock, and Kauffman intervened by filing a claim with the trial court requesting that all stock be transferred back to him on the basis that he was the rightful owner of the stock and that the transfer was nothing more than a temporary trust. The children contended that Kauffman is not the equitable owner of the stock and is not entitled to relief due to the clean hands doctrine.

Conclusion { SYNOPSIS OF DECISION AND OPINION: The Supreme Court of Montana ruled in favor of the Kauffman children, holding that Kauffman was not entitled to relief. Because Kauffman's transfer was in perpetrating an exchange of stock only to avoid paying the judgment legally entered against him, the transaction was a bad-faith action that bordered on a fraudulent transaction.

Analysis—"bad-faith action" { The court reasoned that the rightful owner of the stock was the Kauffman children and that Kauffman's claims were barred by the clean hands doctrine. The court concluded that recognizing his claim would result in a gross wrong being done to the children and the shareholders of the corporation.

WORDS OF THE COURT: CLEAN HANDS DOCTRINE
 "The doctrine of clean hands provides that parties must not expect relief in equity, unless they come into court with clean hands. . . . Thus, no one can take advantage of his own wrong. . . . Court[s] will not aid a party whose claim had its inception in the party's wrongdoing whether the victim of the wrongdoing is the other party or a third party."

This case stands for the proposition that a court will not aid a party who comes with unclean hands. The doctrine of unclean hands prohibits Kauffman from recovering because of his role in the stock transaction.

Stock transferred

Issue—"clean hands"

Rule—doctrine of clean hands

ANALYSIS: How does the court apply the law to this set of facts? Are there any other factors that the court is considering when applying the law? Are there any legal exceptions or privileges that apply to these facts? Was it necessary to deviate from precedent?

CONCLUSION: What was the court's answer to the question posed in the issue phases of this analysis?

Review the case

Use a highlighter (some students may find it helpful to use a different color for reviewing than the color used for scanning) to go over the case one more time. Read the case at a reading speed that is halfway between scanning and comprehensive reading. Highlight sparingly, marking only what you find to be most important. Many students find it helpful to sketch

FIGURE 1A.3

After the *Review* stage, the text would look like this:

CASE 1.3 Kauffman-Harmon v. Kauffman, 36 P.3d 408 (Sup. Ct. Mont. 2001)

FACT SUMMARY: Kauffman created a corporation to hold certain assets in a manner intended to minimize tax liability. After creation of the corporation, a judgment was entered against Kauffman as a result of a lawsuit against him. In order to avoid paying the judgment, Kauffman transferred all of his stock into his spouse's name. His spouse eventually transferred ownership of the stock to several Kauffman children. Several years later, a dispute developed between the children concerning the stock, and Kauffman intervened by filing a claim with the trial court requesting that all stock be transferred back to him on the basis that he was the rightful owner of the stock and that the transfer was nothing more than a temporary trust. The children contended that Kauffman is not the equitable owner of the stock and is not entitled to relief due to the clean hands doctrine.

Stock transferred

Issue—"clean hands"

Conclusion { SYNOPSIS OF DECISION AND OPINION: The Supreme Court of Montana ruled in favor of the Kauffman children, holding that Kauffman was not entitled to relief. Because Kauffman's transfer was in perpetrating an exchange of stock only to avoid paying the judgment legally entered against him, the transaction was a bad-faith action that bordered on a fraudulent transaction.

Analysis—"bad-faith action" { The court reasoned that the rightful owner of the stock was the Kauffman children and that Kauffman's claims were barred by the clean hands doctrine. The court concluded that recognizing his claim would result in a gross wrong being done to the children and the shareholders of the corporation.

WORDS OF THE COURT: CLEAN HANDS DOCTRINE

"The doctrine of clean hands provides that parties must not expect relief in equity, unless they come into court with clean hands. . . . Thus, no one can take advantage of his own wrong. . . . Court[s] will not aid a party whose claim had its inception in the party's wrongdoing whether the victim of the wrongdoing is the other party or a third party."

Rule—doctrine of clean hands

This case stands for the proposition that a court will not aid a party who comes with unclean hands. The doctrine of unclean hands prohibits Kauffman from recovering because of his role in the stock transaction.

out a flowchart or summary of the entire case. After reviewing the case, spot and note the answers to the issue, rule, analysis, and conclusion questions. Then put away the materials, and consider a final question: *What is the fundamental premise of this case?* Write out the answer in two or three sentences, and include it with the case notes for future use. Difficulty in answering that question may be remedied by going back to the *understand* step and refining the issue,

rule, and analysis. Remember that you may not look at the case again for several weeks or months until preparing for an exam. The SUR system increases learning intensity and provides a document ready for use when you are studying the material later.

For an example of the SUR system applied to a full-length case, go to this textbook's website at www.mhhe.com/melvinleb2e.

TABLE 1A.1 Reliable Sources for Legal Research on the Internet

Website Name	Source	Description	URL*
Free and low cost legal research	Georgetown University Law Center—Law Library	One of the very best tools for free and low-cost online research. The website provides an excellent overview, links to different types of free materials, and provides direct links to federal and state statutes and cases. It also summarizes the features and costs of less expensive databases.	www.ll.georgetown.edu/guides/freelowcost.cfm
Free Internet legal sources	University of Washington School of Law	Comprehensive offerings and an easy-to-use layout for finding the law. The site also provides an excellent brochure (in pdf) called “How to Research a Legal Problem: A Guide for Non-Lawyers.”	http://lib.law.washington.edu/research/research.html#states
All Law: The Internet’s premier law portal	Commercial website (primarily generates revenue through advertising)	Very simple layout and direct links that make this website efficient for locating federal or state statutes and cases.	www.alllaw.com/law/
Free legal advice	Commercial website (primarily generates revenue through advertising)	Comprehensive topical information arranged by legal topic (also contains advice related to insurance). However, the site is not useful for finding cases or specific statutes.	www.freeadvice.com/all_topics.php
Online law dictionary	Commercial website (primarily generates revenue through advertising)	Comprehensive law dictionary with search engine.	http://dictionary.law.com

*All Internet research websites may be accessed through this textbook’s website at www.mhhe.com/melvinleb2e.

Finding the Law

The Internet has been the single most important force in providing unprecedented public access to the law. Cases, statutes, and topics on legal information are accessible online and largely free of charge. In addition to Internet services, several commercial services (such as LexisNexis

and Westlaw) provide special versions of case law that are enhanced with summaries, explanations, and a system that ties cases together based on legal topics. Table 1A.1, above, provides examples of reliable Internet sources for legal research. Table 1A.2 illustrates a four-step method that provides a systematic process for finding the law through either an Internet-based or a commercial service.

TABLE 1A.2 Sample Research Strategy Using Internet Sources: CHC-Adams Example

<p>Step 1 Identify precise legal question(s) and try to determine what source of law governs the issue(s).</p>	<p>Questions:</p> <ol style="list-style-type: none"> 1. Is CHC required to permit Adams to take time off for jury duty in a state court? 2. If yes, is CHC obligated to pay Adams for the time he spends on jury duty? <p>Sources: Look in the statutes of the state where CHC employs Adams.</p>
<p>Step 2 Strategize based on resources.</p>	<p>Use Georgetown’s website</p> <ol style="list-style-type: none"> 1. Table of contents: Click on <i>Statutes and Codes: State Codes</i>. 2. Choose <i>State Research Guides</i> and then <i>Pennsylvania resources</i>. 3. Under “Electronic versions” choose <i>Free Web</i>, and use the free search engine for the Pennsylvania code. 4. Use the search engine to find a statute by entering “Jury Duty and Employer.” 5. Click on the first result, and read the statute. Does it help resolve the question(s)?
<p>Step 3 Find an application.</p>	<p>On the same web page (Pennsylvania resources) click on <i>Cases and Courts</i> to use the search engine for any cases involving employers/employees and time off for jury duty.</p>
<p>Step 4 Consult with counsel.</p>	<p>Provide Adams with time off for jury duty, but without pay. Hire a temporary worker for the warehouse (not permitted to discipline or terminate Adams). Icahn checks his plan with his counsel before implementing.</p>

Step 1: Identify a Precise Legal Question

The first step in finding the law is to clearly identify a legal question to answer. Using your knowledge of the levels and sources of law covered in Chapter 1, “Legal Foundations,” try to determine whether the question is best answered by a statute or a case. For example, suppose that Adams is an employee of Coats and Hats Co. (CHC), a business with 45 employees. One morning he informs his manager, Icahn, that he has been subpoenaed for jury duty in a state court and will need the next day off with pay. Because the company is performing a crucial inventory count that week, Adams is needed in the warehouse or, alternatively, a replacement will need to be hired. Icahn wants to know

if CHC is legally obligated to permit Adams to take the time off necessary to serve on jury duty. If so, is the company legally responsible for paying Adams while he is on jury duty? Because the issue is related to employer obligations to employees when called for jury duty to a state court, Icahn would likely find guidance in a *state statute*.

Step 2: Strategize Based on Resources

Once you have determined the basic legal question and potential source of law, the strategy for tracking down the answer is necessarily based on resources. If commercial research services are available to you, it may be advantageous to use them in order to get the

maximum amount of information in the least amount of time. However, such services are typically very expensive and, therefore, are usually limited to law firms, large companies, and academic institutions. Government, municipal, college, and law school libraries have federal and state statutes in book form. However, finding specific information on the law in books or through commercial services may be difficult without extensive training in legal research. Most legal research by nonlawyers is accomplished through the Internet. Pick the appropriate legal website for your research (see Table 1A.1 for the best websites for finding the law). Depending on which site you choose, try to find a general explanation of the topic. Alternatively, use the legal website's search engine to narrow your search in finding the source. In the CHC-Adams hypothetical, discussed earlier, Icahn may wish to use a website that gives a general explanation on rights of employees, but certain issues he seeks may be too narrow for a general explanation. In this case, Icahn will be best off simply using the website's search engine to find the statute in the state in which CHC employs Adams. For example, if CHC was located in Pennsylvania, Icahn would go to the Georgetown Law Center website and follow these steps: (1) Select *Statutes and Codes/State Codes* from the table of contents on the left side to get to Pennsylvania resources, and (2) find the free electronic version of the statutes, and use the search engine to find any relevant statute. Use of the words "jury duty" may be too general, so narrowing it down with modifiers such as "jury duty and employer," helps to hone in on the answer.

A Word of Caution About Internet Sources

While the Internet has made the law more accessible to the public, it has also created an environment where information goes unchecked and unverified. The best sources for legal research are typically the sites maintained by law school libraries. For more general legal

information, websites should be evaluated based on sponsorship (who maintains the website?), authority (are the authors of the information identified, and are they attorneys?), and longevity (how long has the website been in existence?). The websites listed in Table 1A.1 are authoritative, have special features designed for nonattorneys, and are time-tested.

Step 3: Find an Application

Once you have located a statute, learn how the statute was applied in a case. Use the website's search engine, which enables you to find cases by entering the name or citation of the statute. Through the search results, you can read how courts have applied the statute and learn whether any exceptions exist. For example, in the CHC-Adams case, Icahn would use the Georgetown Law Center website to find a case by selecting *Cases and Courts* from the Pennsylvania resources menu and entering terms in the search engine. This will allow him to read how courts have interpreted the statute, if necessary, and help him to understand how it applies to CHC.

Step 4: Consult with Counsel

It is dangerous to make any decision based on legal research by a nonattorney. Once a business owner or manager has a grasp of the issues, she should contact her counsel and discuss the issue and potential consequences of any decisions. The ability to find and understand the law in a business environment should be considered an *enhancement* to helping add value to a company through use of the law in business planning. It is not a substitute for working closely with an attorney. For example, in the CHC-Adams case, based on his research, Icahn is prepared to provide Adams with time off for jury duty (as required by statute) but does not intend to pay him. He will need to hire a temporary worker for the warehouse because he is not permitted to terminate Adams for missing work due to jury duty. However, before implementing his plan, he would consult with his counsel and make any adjustments necessary.