

Chapter 1: Legal Foundations

CHAPTER OVERVIEW

This introductory chapter begins with a very broad based view of the legal landscape including a working definition of and purposes of the law, levels and sources of law (e.g., federal statutory), an introduction to stare decisis, and categories of law (e.g., criminal vs. civil). Equally important, this chapter sets the tone for the entire textbook and course by discussing and provides illustrations of how the law operates in a *business* context.

Teaching Tip: Clean the slate

Students frequently have certain notions and pre-conceptions about the law and legal terms that were generated primarily (or exclusively) by television, Web sites, blogs, and folklore. Ask students to set aside any notions they have about what law is, how it operates, and the meaning of legal terms, so that they may start the course with a clean slate.

KEY LEARNING OUTCOMES

Outcome	Accreditation Categories
Understand the broad definition and origins of law.	Knowledge
List and explain the purposes of the law.	Knowledge and Application; Critical Thinking
Explain the importance and benefits of legal awareness for business owners and managers when planning and implementing business decisions and strategies.	Application; Critical Thinking
Articulate the role of counsel in legal decision making in a business context.	Knowledge
Recognize, explain and give examples of sources of American law.	Knowledge; Application
Understand the legal doctrine of stare decisis.	Knowledge; Application

Classify the law into several broad categories	Knowledge; Application
Differentiate between the concepts of law and equity	Knowledge; Application; Critical Thinking
Identify and apply important equitable maxims	Knowledge; Application

TEACHING OUTLINE

A. Introduction to Law

Points to emphasize:

- Law is a **body of rules** of action or conduct prescribed by controlling authority, and having legal binding force that create duties, obligations and rights as well as a mechanism to resolve disputes arising from those duties and rights.
- **Jurisprudence:** The philosophy behind the law, including natural law (moral values form the basis for all law), positivists (agreed-upon laws enforced uniformly and strictly) and legal realism (law is a social institution accounting for social and economic realities to promote fairness).
- **Purposes of Law:** (1) **System of order** that defines crimes and levies punishment for violations; (2) system for **resolving disputes** by providing a basis for deciding the legal interests and rights of the parties; (3) creating **reliability** in business planning and commercial transactions by promoting good faith dealing among merchants and consumers.
- **Language of the Law:** Primarily a combination of Latin, early and modern English, and French, a basic understanding of which is useful to maximize the value of interaction between business managers and attorneys.

B. Legal Decisions in a Business Environment: Theory to Practice

Points to emphasize:

- 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.
- **Legal Insight and Business Strategy:** Reference to Table 1.1: Expansion Options and Potential Legal Impacts
- **Role of Counsel:** Managers often work closely with business attorneys, resulting in business opportunities, reduced costs, and limitation of risk and liability.

TABLE 1.1 Expansion Options and Potential Legal Impacts

Option	Area of Law	Potential Legal Impact
<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.	■ Contracts ■ Property/environmental ■ Employment and labor ■ Tax ■ Antitrust	■ Contract law governs negotiations and agreements for the acquisition. ■ If the acquisition involves any land purchase, real estate law (such as zoning) and environmental law must be considered. ■ 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. ■ The transaction may create tax liability under local, state, and/or federal laws. ■ 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.
<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.	■ Securities ■ Intellectual property ■ Administrative	■ Any solicitation by IPC to sell shares of its business to the public is highly regulated by securities law. ■ 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. ■ Federal regulatory agencies have guidelines for the advertising and labeling of products.
<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.	■ Jurisdiction ■ International	■ Website expansion may result in IPC being subject to the jurisdiction of more out-of-state courts than under its previous business model. ■ IPC may be subject to international agreements and treaties regarding sales and intellectual property.

C. Sources and Levels of American Law

Chalk Talk: Sources and Levels of Law

Covering sources and levels of law in tandem makes sense, but students often have trouble understanding the interplay between the two. I use a diagram on the board and fill in as I go along asking students for examples of each along the way.

	Constitutional	Statutory	Admin	Common
Federal	First Amendment (political speech by corporations)	Patent Act	OSHA	“gap filler”
State	Structure of state gov’t	Formation of an LLC	Environmental (regulation of hazardous materials)	Contracts for services.
Local	Charter: local gov’t	Zoning (residential vs. industrial)	Sanitary conditions in restaurants	N/A

Points to emphasize:

- Modern law regulating businesses and individuals is generally a **combination of the primary sources of law**: constitutional law, statutory law, common law, and administrative (regulatory) law.
- **Constitutional Law**: Exists at state and federal levels as the supreme law, providing the foundation for all other law to prescribe the basic **structure** and powers of a particular government body and to protect certain **rights** of individuals and business from government encroachment.
- **Statutory Law**: Exists at the state, federal and local levels of law, created by a **legislative body** and approved or disapproved by the executive branch.
 - ***Statutory Scheme and Legislative History***: When interpreting statutes courts look to the structure of the law itself (statutory scheme) and to the records kept by the legislature in drafting the statute (legislative history).

- ***Finding Statutory Law:*** The official publication of federal statutory law is in the United States Code and it is arranged by title and divided into chapters and sections that form a citation.
- ***Interpreting Statutes:*** When interpreting statutes, courts initially apply the *plain meaning rule*, which means that if the words in the statute have clear and widely understood meanings, the court applies the statute in accordance with those meanings.

CASE 1.1: U.S. v. Ulbricht

Facts: A federal Grand Jury indicted Ross Ulbricht, also known as Dread Pirate Roberts (Ulbricht), for, among other things, conspiracy to launder money obtained from illegal activities. Prosecutors alleged that Ulbricht was engaged in narcotics trafficking, computer hacking, and money laundering conspiracies by designing, launching, and administering a website called Silk Road as an online marketplace for illicit goods and services. He allowed payment only via bitcoin, an anonymous and untraceable form of digital currency. Thousands of transactions allegedly occurred over the course of nearly three years—sellers posted goods when available; and buyers purchased goods when desired. Ulbricht filed a motion to dismiss arguing that he could not be guilty of money laundering because the use of bitcoins did not fit into the statute’s requirement that money laundered be a result of a “financial transaction.”

Issue: Does the use of virtual currency such as bit coins fit into the money laundering statute requiring that the laundering be the result of a financial transaction?

Ruling: Yes. The plain meaning of the statute indicates that “funds” may be defined as bitcoins because they are used to pay for certain things or act as a medium of exchange.

Answers to Case Questions:

1. The heart of Ulbricht’s argument is that the statute doesn’t fit his activities or virtual currency. His point about IRS’s treatment of bitcoins as property bolsters his argument that bitcoins cannot be squared with the text of statute (funds).

2. Perhaps. The court plainly believed that Ulbricht created the silk road primarily for illicit activity and therefore he had knowledge that the funds were being “laundered.”

3. *Focus on Critical Thinking:* This question is intended to stimulate discussion about the appropriate role of judicial interpretation absent explicit language in the statute. On one hand, if Congress had wanted to include bitcoins as “funds” under the statute, wouldn’t they have done it? On the other hand, shouldn’t courts act as a gap-filler in cases where the legislature could not have accounted for a particular use of funds via bitcoins?

Teaching Tip: Reading cases

This is the first case featured in the textbook and an ideal time to discuss the importance of cases in the law. The hybrid format gives students a summary of the facts and of the precise holding related to the point in the text. That point is then reinforced by a short excerpt from the opinion (“Words of the Court”). This is also an ideal time to point out the SUR (Scan, Understand, Read) system featured in **Appendix A of this chapter:** A Business Student’s Guide to Finding and Understanding the Law.

- **Big Data and Information Law-** there continues to be a significant amount of interest in the business community and media surrounding blockchain technology. By its nature, blockchain technology is difficult to regulate because one of its essential features is that it exists outside of any government control.
- **Common Law:** Law made by **appellate courts** and is based on the fundamentals of previous cases that had similar facts.
 - **Origins:** Deep-seated in British common law that has developed over several centuries beginning around 1066.
- **Stare Decisis and Precedent:** Appellate courts create precedent and under the doctrine of stare decisis, lower courts apply the precedent to new cases with similar facts.

- ***Stare Decisis and Business:*** Stare decisis allows business to have some **degree of confidence** that the law will remain reasonably consistent. (Reference to Table 1.2: Laws That Impact Business [P.13])
- **Departing from Precedent:** Strict adherence to precedent has a significant drawback- it does not allow for evolving societal standards of behavior or expectations.

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- **Administrative Law:** The source of law that regulates the exercise of authority by **administrative agencies**.

D. Secondary Sources of Law

Points to emphasize:

- Secondary sources function to increase the level of uniformity and fairness across all 50 states, however, they have no independent authority, nor are they legally binding.
- **Uniform Model Laws:** Drafted by legal experts, in hopes that they will be used or adopted by state legislature to provide uniformity in laws between the states (i.e. the U.C.C.).
- **Restatements of the Law:** Collections of uniform legal principles in a specific area of law that are designed to reduce the complexity of judicial decisions.

TABLE 1.2 Examples of 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

CASE 1.2 South Dakota v. Wayfair, Inc.

Facts: South Dakota taxes the retail sales of goods and services. Sellers are required to collect and remit the sales tax to the state, but if they do not, then consumers are responsible for doing so. Under *National Bellas Hess, Inc v. Department of Revenue of Illinois* and *Quill Corp. v. North Dakota*, South Dakota may not require a business that has no physical presence in the state to collect its sales tax. Because the state was losing sales tax revenue, it passed a law requiring out-of-state retailers to collect and remit the sales tax to the state "as if they had a physical presence in the State." On appeal, the State supreme court ruled in favor of the retailers citing the *Quill* decision.

Issue: Are the *National Bellas Hess* and *Quill Corp.* cases controlling?

Holding: The United States Supreme Court overruled the State supreme court and found in favor of South Dakota. The Court held that the rule of *Quill* requiring a "physical presence" in the State is unworkable given modern technology.

Answers to Case Questions:

1. Before the *South Dakota v. Wayfair, Inc.* case, the U.S. Supreme Court's precedent interpreted the Commerce Clause of the U.S. Constitution as prohibiting the states from regulating interstate commerce in a manner that was discriminatory or imposed an undue burden. As applied to state taxes, the Court cited the four-factor *Complete Auto Transit* test, which held that a state tax will be

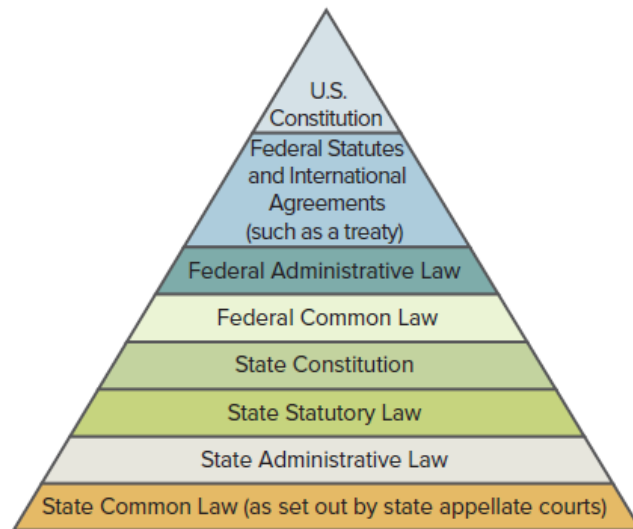
sustained under the Commerce Clause if the tax: (1) applies to an activity with a substantial nexus (i.e., a connection or link) with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state. Through its prior rulings in *National Bellas Hess* and *Quill Corp.*, the U.S. Supreme Court held that, at least with respect to sales tax, a seller that lacked any direct or attributed physical presence in a state could not be considered to have a substantial nexus with that state under the Commerce Clause. This was known as the “physical presence” test.

2. The Court overruled *Quill* and *National Bellas Hess* because it decided that the physical presence nexus standard was “unsound and incorrect.” According to the majority opinion in *South Dakota v. Wayfair*, the physical presence standard constituted a “serious, continuing injustice” faced by the states. The Court opined that the doctrine had become “further removed from economic reality,” resulting in significant state revenue losses. The majority explained that: (1) the physical presence standard “is not a necessary interpretation of the requirement that a state tax must be ““applied to an activity with a substantial nexus with the taxing State;”” (2) *Quill* does not resolve market distortion, but instead creates it; and (3) *Quill* “imposes the sort of arbitrary, formalistic distinction that the Court’s modern Commerce Clause precedents disavow.”

3. *Focus on Critical Thinking:* Student responses to this question will likely vary. All areas of the law either are or could likely become affected by technology in the future. Examples include: alternative dispute resolution; banking and negotiable instruments; civil and criminal procedure; e-contracts; employment law; ethics; intellectual property; privacy and security; real property; and wills and trusts.

Figure 1.1 : Hierarchy of Primary Sources of Federal and State Law

FIGURE 1.1 Hierarchy of Primary Sources of Federal and State Law



Concept Summary: Sources of Law

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

E. Categories of Law

Points to emphasize:

- Broad categories based on classification related to a particular legal function or a right afforded by law are helpful in understanding the “big picture” of our legal system.
- **Criminal Law versus Civil Law:** Civil laws are designed to compensate parties for losses as a result of another’s conduct, while criminal laws are a protection of society, and the violation of criminal laws results in penalties to the violator such as fines or imprisonment.

- **Substantive Law versus Procedural Law:** Substantive laws provide individuals with rights and create certain duties, while procedural laws provide a structure and set out rules for pursuing substantive rights.
- **Law versus Equity:** Where remedy at law is inadequate, an injured party may also obtain a remedy at equity.
 - Remedies at law generally take the form of **money damages** while **equitable remedies** generally include an injunction or restraining order, and specific performance. **See Case 1.4 for an equitable remedy**

CASE 1.3: Wilcox Investment v. Brad Wooley Auctioneers, et al

Facts: Wilcox entered into a contract with Wooley Auctioneers, Inc. to market and sell approximately 333 acres of real property owned by Wilcox in Arkansas. It was to be an “absolute” auction, meaning that the property would be sold to the highest bidder regardless of price. As the date of the auction approached, Wilcox expressed reservations about the auction to Auctioneers but decided to go through with the auction. Wilcox did not attend but was represented by two of his children and his attorney. Shollmier was the highest bidder with a bid of \$235,000. Wilcox, who claimed the property was appraised in excess of \$950,000, refused to complete the sale.

Issue: Is specific performance an appropriate remedy or can money serve as an adequate remedy.

Ruling: Shollmier is an innocent, non-breaching party. There was no evidence of collusion and Shollmier should be given title to the property as promised in the contract.

Case Questions:

1. Money wasn’t adequate because Shollmier contracted for the real estate via his highest bid. Since Wilcox breached his promise before the transaction was contemplated, Shollmier isn’t out of pocket, but is entitled to purchase the property upon the terms and conditions set forth at the auction.
2. Wilcox is alleging that Shollmier conspired with the auctioneers to complete a quick sale at a discounted rate. However, the jury found no evidence of collusion.

3. *Focus on Critical Thinking:* This question asks students to think proactively about the law. Wilcox could have stipulated that a minimum auction price be paid as a condition of sale. Instead, he agreed to an “absolute auction” where the seller has virtually no protection on price.

- ***Important Equitable Maxims:*** Intended to be broad statements of rules that are based on notions of fairness and justice in applying the law.
 - ***Equity Aids the Vigilant:*** 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.
 - ***Substance over Form:*** When applying the law, courts look to the intent of parties involved and adhere to a standard of good faith instead of applying the black letter law in a way that would violate fundamental principles of fairness and consistency.

Talking Points: Additional Discussion Questions on Substance over Form

1. Has anyone in this class ever been treated unfairly because the letter of law was applied over fundamental fairness?
2. Has the university/college or any of your professors ever enforced “form over substance” which resulted in you being treated unfairly?
3. In a business context that is absent of any fraud, should courts have the right to decide what is “fair” in a transaction or contract?

- ***Clean Hands Doctrine:*** Courts are not inclined to decide a dispute based on **technicalities** that benefited a party who acted dishonestly.

TABLE 1.3 Equitable Maxims

Maxim	Rule	Example
Equity aids the vigilant	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.	Statute of limitations imposes a deadline on when an aggrieved party must file a claim. After the deadline has passed, the party is barred from recovering any losses or damages.
Substance over form	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.	Blackwell signs an agreement that she is a limited partner. In substance, she acts like a general partner. Courts will treat her as a general partner despite what the parties call themselves.
Clean hands doctrine	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.	Kauffman fraudulently transfers stock to his brother to avoid paying a legal judgment entered against him. When a dispute arises with his brother, Kauffman sues to try and recover the stock. Kauffman is barred from recovering the stock because he committed fraud in transferring it to his brother in the first place.

STRATEGIC LEGAL SOLUTIONS

Note to Instructor: This is a new feature for this edition and incorporates the use of business strategy into the legal environment. It is important for students to read this overview (and refer back when necessary) which lays out four basic strategies that are discussed throughout the text. The end of each chapter features a “Strategy 101” problem and assignment that is related to one or more subjects covered in that chapter. The examples are intended to connect with business students and to focus on the law as a strategy rather than as a set of rules. For an excellent discussion of the integration between law and strategy, see *American Business Law Journal*, Volume 47 (4) [Winter 2010] where the entire periodical is devoted to the law as a source of strategic advantage. Also, see “Finding the Right Corporate Legal Strategy” a groundbreaking article in MIT’s *Sloane Management Review* by Professors Robert Bird and David Orozco.

Strategy 1: Noncompliance

Example: UPS policy of noncompliance for parking citations. ‘Part of the cost of doing business’

Issues: Cost-benefit analysis; Ethical considerations

Discussion: Is it socially responsible to park in a handicapped spot or fire lane?

Strategy 2: Avoidance

Example: Pfizer’s “tax inversion merger” with Irish Company Allergan to avoid U.S. tax burden.

Issues: Cost-benefit; Ethical considerations; U.S. tax policy; Stakeholders

Discussion: Are there any cases in which relocating to a more favorable regulatory environment is justified? Can you think of any examples? (e.g., Uber moving from California to Arizona to test driverless cars).

Strategy 3: Prevention

Example: Disclaimers in consumer contracts; Limiting liability at Fenway Park

Issues: Consumer awareness/fairness; Loopholes

Discussion: In what ways can counsel work with a business to anticipate potential legal pitfalls? (e.g., a labor audit to be sure employees are correctly classified).

Strategy 4: Value Creation/Competitive Advantage

Example: Differentiating one's business model via durable forms of intellectual property law. Google co-founders were required to assign their first algorithm to Stanford since they developed it while research students there. But subsequent algorithms are trade secrets that don't expire (like patents do). Disney uses lobbying to extend copyright protection for Mickey Mouse.

Discussion: What other opportunities could business managers use to create value? Could data analytics be used to avoid liability for negligence?

CHAPTER REVIEW QUESTIONS

Answers and Explanations

END OF CHAPTER PROBLEMS, QUESTIONS AND CASES

Theory to Practice

1. Galaxy's business objectives will necessarily involve a lease for the store and therefore contract law will impact business planning. The lease may also be governed by a landlord-tenant law. Jackson's plan to hire new employees to staff the stores will involve aspects of employment and labor law. [Ties to Table 1.1]
2. Students benefit from understanding that Galaxy will not have in-house counsel, but will rely on a law firm for advice. In this case, Galaxy's management could work with counsel in understanding various options and being proactive in negotiating a favorable lease and implementing a compliance system to ensure proper hiring and employment practices. [Ties to the "Role of Counsel"]
3. Answer based on Table 1.2

Law	Source	Level
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Contracts for services/land	Primarily common law	State
Employment discrimination	Primarily statutory and administrative	Primarily state and federal, some local
Tax	Statutory and administrative	Federal, state, local

Galaxy liability protection could come in several forms. First, the liability can be limited through various provisions in the lease. Second, the liability of Galaxy's principals may be protected through choosing an appropriate business entity.

4. In this case, Galaxy should learn how the IRS has taxed any similar transactions in past. A primary purpose of the law in a business planning context is *reliability*: similar cases, with similar facts, should be treated (in this case taxed) in a similar way. [Tied to the importance of understanding how stare decisis and precedent can be used in business planning]
5. The equitable maxim of "equity aids the vigilant" may apply to this situation. This maxim favors Jackson/Galaxy in this case because it was Holmes who failed to pursue his legal rights for such a long period of time. [Tied to "Important Equitable Maxims"]

Manager's Challenge

A sample answer to Manager's Challenge is provided in Connect.

Case Summary 1.1: Equity and Fairness: Sokoloff v. Harriman Estate Development Corp.

1. Can Harriman withhold the plans from Sokoloff?
 - A. No. Doing so would clearly breach a duty owed to Sokoloff.
2. What legal theories or maxims would a court consider in deciding this case?
 - A. The court would consider the legal theories of equitable relief and/or a remedy at law. The legal maxims that could apply are substance over form and the clean hands doctrine.

3. How should the court rule and why?
 - A. The court ruled in favor of Sokoloff and ordered specific performance (deliver the plans).

Case Summary 1.2: Statute of Limitations: Jones v. R.R. Donnelley & Sons Co.

1. Which statute of limitations governs and why?
 - A. The federal statute of limitations governs because Jones is bringing a suit that alleges a violation of federal antidiscrimination statutes, thus bringing the claim within federal jurisdiction.
2. Will Jones be able to sue Donnelley?
 - A. Yes, assuming that the cause of action is initiated after 1990, the three years past is within the four-year statute of limitations.

Case Summary 1.3: Clean Hands Doctrine: Day v. Case Credit Corp.

1. If the court applies the clean hands doctrine, will Case be able to recover the farm equipment because Day is unable to make payments? Why or why not?
 - A. No. Courts are not inclined to decide disputes based on technicalities that benefited a party who acted dishonestly and here the transaction was a bad-faith, fraudulent transaction.
2. Are Case's hands clean? Why or why not?
 - A. No. Case's hands are stained by bad faith, misrepresentation and deceit in their awareness of the forgery followed by a failure to act.

Case Summary 1.4: Cargill v. Montfort

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?
 - A. Relief in equity because they did not suffer monetary damages.

Case Summary 1.5: Arizona v. United States

1. Who prevails and why?
 - A. The US won at the appellate level based on federal preemption.
2. If a federal law is ineffective, should a state have the right to legislate in that area without federal intervention?
 - A. Yes, so long as the state law does not frustrate the purpose of the federal law.

Case Summary 1.6: In re: Sedimentation Pollution Act

1. How is precedent created, and how is it applied in future cases?
 - A. By courts of authority starting with the date of the decision.
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?
 - A. No. Only courts of authority set precedent. Panels are not bound by each other's decisions.
3. If precedent has been set by a state appellate panel, who has the power to overrule that precedent?
 - A. Courts of authority (i.e., appellate courts)