

Chapter 1

Law as a Foundation for Business

Learning Objectives

The purpose of this chapter is to introduce the students to the subject of law and to some classifications of its subject matter. In addition, it is designed to instill in them respect for the role of the “rule of law” in society and that the judicial system is the most important stabilizing force in society. It should create an awareness that law is a foundation for the private market and “property” as a legal concept underpins that market and contributes to the maximum wealth of nations through productivity. This chapter also describes stare decisis, the basic sources of American law, and sanctions that can be imposed when the law is not followed.

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Teaching Outline

I. Introduction

A. Why Law and Regulations Are Fundamental Foundations for Business (LO 1-1)

Emphasize:

- That by studying the legal and regulatory environment of business, students will gain an understanding of basic legal vocabulary and gain the ability to identify problematic situations that could result in liability.
- That because of the positive role lawyers can play, they are increasingly being asked to join corporate boards.
- Sidebar 1.1 titled ‘Sustainability and Integrity: Cautionary Tales of Legal Liability.’

II. Law, the Rule of Law, and Property

A. Law

Emphasize:

- The simple definition of law. It can be elaborated by observing that law is a rule-based, state-enforced formal ordering system with moral elements.
- That adequate law and legal institutes promote the certainty and trust necessary for complex, long-term business arrangements. In an economic sense, they lower the costs of transacting business.

Additional Matters for Discussion:

- Emphasize that law can glue together diverse peoples of different backgrounds into very large, organized groups.
- Note that law is a formal social force, meaning that laws come from the state and are usually written down and accessible so those who need to understand and obey them can.
- Underscore that written laws mean little unless they can be promptly and fairly enforced.
- It is not too early in this chapter to ask students whether the lack of law and strict regulation facilitated the economic crash and recession that began in 2008.
- Ask students to comment on how mistrust of law and lawmakers precipitated the “Occupy Wall Street” and other “Occupy...” movements that arose in 2011.

B. The Rule of Law

Emphasize:

- That under a rule of law, laws are generally and equally applicable.
- That lack of the rule of law internationally has produced hundreds of calls for it in the last several years by business and political leaders. Get students to search for rule-of-law references in computer databases.
- That the rule of law is an ideal rather than a complete fact in even the most democratic nation.

Additional Matters for Discussion:

- Get students to discuss why the managing director of J.P. Morgan Chase called the rule of law “a cornerstone of free trade.”
- Ask students why the rule of law tends to produce rules that benefit everyone. Answer: Because laws apply generally and equally to everyone, the only way lawmakers can benefit themselves is by benefitting everyone. This answer is theoretical, of course. Lawmakers are often benefited individually for making laws that favor special interests.
- Ask students to imagine how society would be with no laws. What if the governor of one’s state announced that tomorrow would be “No-Law Day,” meaning that no law would be enforced, no police would be present, and no penalties would result from anyone’s actions. What would the students do? One is likely to find that after a few fleeting and whimsical thoughts, they would agree that they would primarily act to protect their real and personal property.

C. Property (LO 1-2)

Emphasize:

- The two meanings of property.
- That property is not the resource or thing itself. It is a right (or series of rights).
- That the property right gives a major incentive to develop resources.
- That the exclusionary right of property provides a basis for the private market and modern business.

Additional Matters for Discussion:

- Ask students to discuss the incentive to grow and prosper and the incentive to innovate and progress under a system with a right to private property ownership and a communist

system where private ownership of property is greatly diminished for most. Would they even be in school if accumulation of property rights were not attainable?

D. Property in its Broadest Sense

Emphasize:

- How, in its broadest sense, “property” is the central concept of Western legal systems.
- How property can be thought of as the hub of a wheel and the various legal topics studied in the text as spokes of the wheel. Law and the rule of law provide the unifying rim of the wheel. (Refer to Figure 1.1)
- That for Madison and other constitutional framers, property protected not only physical resources like land but also human rights like freedom of speech, freedom of religion, and freedom from unreasonable intrusion by the government.

Additional Matters for Discussion:

- Ask students to discuss the statement: “Bill Gates and your professor have equal property.” The point is to examine the confusion between “resources” and “property.” Arguably, although Bill Gates and the student may have vastly different amounts of resources, he and the student have the same right to these respective resources, thus the same “property.”
- In Federalist Paper 10, Madison wrote: “Property... in its particular application means that ‘domination which one man claims and exercises over the external things of the world, in exclusion of every other individual.’ In its larger and juster meaning, it embraces everything to which a man may attach a value and have a right; and *which leaves to everyone else a like advantage*. In the former sense, a man’s land, or merchandise, or money is called his property. In the latter sense, a man has property in his opinions and the free communication of them. He has a property of peculiar value in his religious opinions, and in the profession and practice dictated by them. He has property very dear to him in the safety and liberty of his person. He has an equal property in the free use of his faculties and free choice of the objects on which to employ them. In a word, as a man is said to have a right to his property, he may be equally said to have a property in his rights.”
- Madison’s “larger and juster meaning” of property creates all sorts of opportunities for discussion with students. Note that although a system of property is basic to private business in the modern nation, it does not preclude redistribution of resources for education, health, and relief of poverty and adversity, etc. Even as the American revolutionaries maintained “no taxation (of our individual resources) without representation,” they appreciated the necessity of appropriate taxation (of one’s resources) with democratic representation.
- The importance of the broader sense of private property in the common law grows out of the Magna Carta. From the 13th through the 18th centuries, the importance of private property created constitutional tension between the English monarchs and their subjects. The monarchs often claimed in essence that they owned the nation, its land, and its produce, yet in opposition to this there was a growing sense that people owned things privately and could be taxed on this private ownership only through their own representative consent. Thus, the British colonists in the new world claimed they could not be taxed without representation. The Sons of liberty, one of the first revolutionary groups, had as their slogan “Liberty, Property, and no Stamps.”

E. Jurisprudence

Emphasize:

- The various schools of jurisprudence (natural law, positive law, historical school, sociological jurisprudence, and legal realism).
- How the various schools of jurisprudence overlap.
- That the word jurisprudence also refers to the general body of law interpreted by judges rather than legislation.

II. Classifications of Law

A. Common Law and Civil Law (LO 1-3)

Emphasize:

- That the “common law” countries are those that were colonized by England and take the legal approach of that nation.
- That common law emerged as judge-made law and even today emphasizes the importance of judges in the legal system.
- That civil law relies on legislation rather than judicial decisions to determine what the law is. Under civil law, courts are primarily fact-finding bodies.

B. Public and Private Law

Emphasize:

- The distinction between public and private law.
- That constitutional law, administrative law, and criminal law are three of the main sources of public law.
- That property law, contract law, and tort law are three of the main types of private law.

C. Civil Law and Criminal Law

Emphasize:

- That for administrative purposes, courts usually separate criminal actions from all other lawsuits.
- That civil law as a classification of law is not the same as civil law as discussed previously as a system of law. The context of the term’s use must be considered when defining the term.

- Sidebar 1.4 titled “Goldman Sachs: ‘Rogue’ Bankers and a \$1 Billion Legal Charge”

D. Substantive Law and Procedural Law

Emphasize:

- The distinction between substantive and procedural law.
- That substantive rules of law define rights and duties, while procedural rules of law provide the machinery for enforcing those rights and duties.

IV. Sources of Law (LO 1-4)

A. Federal Law

Emphasize:

- That federal law is a very important source of law. It includes the U.S. Constitution, which is the supreme law of the nation.
- That any law, federal or state, that conflicts with the Constitution is said to be void and has no legal effect.
- That next in the hierarchy of federal law comes the legislation passed by Congress, also called “acts” or “statutes” (collections of legislation, often on the same subject, are codes).

B. State Law

Emphasize:

- The distinction between a statute, a code, and an ordinance.
- The benefits of uniform legislation, especially the Uniform Commercial Code (UCC).

Additional Matter for Discussion:

- The problem of clear, concise, and accurate statutory drafting. Have the students write a definition for a law prohibiting “conduct unbecoming a student.”

C. Judicial Decisions or Case Law

Emphasize:

- How a judicial opinion becomes a precedent and how a case is cited.
- The distinction between a holding of a case that establishes precedent and dicta.

Additional Matters for Discussion:

- Discuss how in America’s property-based legal system, resolving disputes over the meaning and application of the law is imperative. Judicial decision-making formally resolves disputes. Talk about the need to have impartial judges.
- Have the students express their views on originalism. Do they think that originalism can be fair and effective over 200 years after the Constitution was drafted?

Advantages

Emphasize:

- The importance of stare decisis.
- The advantages of stare decisis.

Disadvantages

Emphasize:

- That the disadvantages of case law include the volume of cases, conflicting precedents, dicta, rejection of precedent, and conflicts of law.
- The problem of conflict of laws and the attempts at resolution.

Additional Matters for Discussion:

- Discuss how a wrongly decided case can create bad precedent (such as *Plessy v. Ferguson*, and how the U.S. Supreme Court corrected it in *Brown v. Board of Education*).

D. Sources of Law Hierarchy in Review

Emphasize:

- That law comes in a hierarchy.
- That law higher in the hierarchy overrules or preempts lower law.

E. Legal Sanctions

Emphasize:

- That sanctions are necessary to encourage or force compliance with the law.
- That the Fourteenth Amendment mandates that individuals receive due process.
- That the right of an individual to take another person's resources (especially money) because that person has failed to meet the requirements of the law (e.g., the breach of a contract) is known as a remedy.

F. Sanctions for Criminal Conduct

Emphasize:

- That criminal actions may result in one or more of the five sanctions listed (death, imprisonment, fine, removal from office, disqualification from holding any office and from voting).
- That the purposes of sanctions are to protect the public and deter further criminal conduct.
- The distinction between felonies and misdemeanors.

Additional Matters for Discussion:

- Draw attention to the fact that as society changes, criminal law changes. Point out that miscegenation and homosexuality were both once considered crimes.
- Have the students debate whether certain actions that are now criminal should be. For example, drug use, alcoholism, gambling, and prostitution.
- Discuss the growth of “white-collar” crimes such as income tax evasion, embezzlement, bribery of foreign officials, computer fraud, and price fixing. Have the students discuss the appropriate punishment for those convicted of white-collar crimes.
- Mention that Chapter 13 will cover criminal law in detail.

G. Sanctions for Breach of Contract

Emphasize:

- The importance of contract law to the business community.
- That when one party to a contract fails to do what they agreed to do, a breach of contract occurs.
- That the usual remedy for a breach is a suit for dollar damages. These damages, called compensatory damages, are awarded to make the victim of the breach “whole” in the economic sense.
- That in addition to compensatory damages, breach-of-contract cases may award consequential damages in some circumstances.
- That in some circumstances, the remedy of an injured party may be a decree of specific performance—an order by the court commanding the other party to perform the bargain as agreed.

Additional Matter for Discussion:

- Note that contracts will be discussed in detail in Chapters 8 and 9.

H. Sanctions for Tortious Conduct

Emphasize:

- That a tort is a civil wrong other than a breach of contract.
- The theory of damages in tort cases.
- That there are three types of torts: intentional, negligence, and strict liability.
- That punitive damages—also called exemplary damages—are also appropriate when the tort is intentional, or the unreasonable conduct is extremely severe.

Additional Matter for Discussion:

- Mention that tort law will be discussed in detail in Chapter 10.

I. Sanctions for Violating Statutes and Regulations

Emphasize:

- That statutes at both the federal and state levels of government impose a variety of sanctions for violating the statutes or regulations of administrative agencies adopted to accomplish statutory purposes.
- That most statutes include provisions for the imposition of fines and penalties.
- That the sanctions imposed for violating statutes or administrative agency regulations are an important part of enforcing the property-based legal system.

Additional Matter for Discussion:

- Review the Concept Summary pertaining to legal sanctions.

V. Property and Corporate Governance

Emphasize:

- That under the rule of law in a property-based legal system, all persons have an equal right to their resources.

- That much, if not most, business in the United States is transacted through large corporate business organizations.
- The definition of a corporation (a business chartered by the state to do business as a legal person in a certain form of organization).
- That corporations are owned by shareholders but controlled by the boards they elect and the managers the boards appoint.

A. The Specific Sense of Corporate Governance

Emphasize:

- That corporate governance defines the legal relationship between corporate agents like managers or boards of directors and the shareholder owners of the corporation.
- That due to the complexity of modern corporations, there are sometimes breakdowns in corporate governance.
- That corporate governance can fail even when corporate managers do nothing illegal.

B. The General Sense of Corporate Governance

Emphasize:

- That in a larger sense corporate governance includes the legal property relations that large businesses have with each other, with their customers, and with society.
- That most chapters of the text deal with corporate governance, at least in the larger sense.
- How the economic crash of 2008 was in part caused by the lack of adequate corporate governance.

Additional Matter for Discussion:

- Note that corporate governance will be discussed in detail in Chapter 14.
- Review Sidebar 1.5 (“Corporate Social Responsibility: Good Faith”)

Answers to Review Questions and Problems

Introduction

1. *Why Nations are Economically Weak or Strong?*

- a. Answer should discuss dependency theory, natural resources, education, technology, the private market, and the legal system.
- b. A “proper” legal system that is adequately enforced.

Law, the Rule of Law, and Property

2. *Law*

- a. Law is a series of rules laid down by the state and backed up by enforcement. Both law and custom maintain order in society, but law is more formal and easier to change, whereas custom usually precedes law.
- b. The role that courts and policy play in the legal system include enforcement, application, and interpretation.

3. *The Rule of Law*

- a. A system of law defined by generally and equally applicable rules. The general and equal application of rules differentiates the rule of law from law as the commands of the state.
- b. The rule of law is “an ideal rather than a complete fact” because lawmakers are often susceptible to favoring special interests.

4. *Property*

- a. Either a “bundle of rights,” or a single right to exclude others from one’s resources. Property is a right. Resources are what people use to satisfy their wants or needs.
- b. Property is the method the state uses to create the maximum incentive in society for the generation of resources. In heterogeneous modern nations, property is the specific legal foundation for private enterprise.

5. *Property in its Broadest Sense*

- a. The right to exclude others from one’s resources and to keep them from infringing on what is one’s resources pervades Western legal systems. If the right of property is at the hub of these legal systems, contract is that important spoke whose rules provide for the transfer of an owner’s resources, tort is that spoke which provides compensation for wrongful injury to one’s resources, criminal and administrative law both protect and regulate the resources of owners, and even constitutional rights guarantee one a right to exclude the state itself from what James Madison termed one’s “faculties” (facultative resources).
- b. Madison means that the American constitutional rights themselves—such as freedom of speech—can be thought of as subsets of the broad right to exclude others, especially the state, from one’s resources.

6. *Jurisprudence*

- a. The definition should discuss the philosophy of law and natural law, positive law, historical jurisprudence, and sociological jurisprudence (includes legal realism).
- b. Natural law speaks of enduring principles of law, whereas sociological jurisprudence believes law changes to meet changing conditions.

Classifications of Law

7. *Common Law and Civil Law*

- a. The common law legal system emphasizes the role of judges in determining the meaning of laws and how they apply. Because the U.S. was colonized by England where the common law originated, the U.S. has continued to use the system.
- b. The primary distinction is the emphasis that common law places on courts interpreting law, whereas in civil law the emphasis is on the legislature interpreting law.

8. *Public and Private Law*

- a. Public law involves the regulation of society by the state. Criminal law, constitutional law, and administrative law are three examples.
- b. Private law regulates relations between and among individuals. Property, contracts, and tort law are three examples.

9. *Civil Law and Criminal Law*

- a. Civil law does not apply imprisonment to punish its violation, but criminal law, which is an offense against the state, does.
- b. Civil law applies both to noncriminal law and to the system of law that emphasizes legislative acts and interpretation.

10. *Substantive Law and Procedural Law*

- a. Substantive law regulates the rights and relationships between people or people and the state, whereas procedural law specifies the methods and means by which substantive rules are made and administered.
- b. Contract law is substantive law. Requiring 30 days to answer a complaint is an example of procedural law.

Sources of Law

11. *Federal Law*

- a. It means that all other laws are subordinate to the Constitution.
- b. The federal constitution is the supreme law of the entire United States and overrides state constitutions when they conflict with the federal constitution.

12. *State Law*

- a. Acts and statutes are two additional terms for legislation.
- b. Uniformity of law is important to business because it adds certainty, stability, and predictability to business decision making. Codifying law is one way of achieving uniformity; federalizing state laws, another. The most significant law affecting business is the Uniform Commercial Code.
- c. Administrative agencies allow groups of designated individuals to specialize in narrow areas and under a delegation of appropriate authority, to create regulations in those areas to regulate business and industry.

13. *Judicial Decisions or Case Law*

- a. *Stare decisis* includes the doctrine of prior precedents. It provides certainty, stability, and predictability. There are often conflicting precedents in multiple jurisdictions and, overall, a huge number of precedents.
- b. The precedent is created from a case opinion's holding, which addresses the specific issue(s) before the court. Dicta consists of whatever else a court might write in its opinion. *Stare decisis* obligates future courts to follow only precedent.
- c. Students' answers will vary. Conflicts of law principles usually state that the laws of the state where the accident occurred are the applicable substantive laws.

14. *Sources of Law Hierarchy in Review*

- a. Students' answers will vary. If a judicial decision interprets legislation as meaning a certain thing, can the legislature pass a new law that contradicts the court's interpretation?

15. *Legal Sanctions*

- a. Legal sanctions are important in a property-based legal system because law is enforced by taking a person's life, freedom, or the resources they own.
- b. A sanction is a method or means that encourages or forces compliance to the law. A remedy rectifies a wrong.

16. *Sanctions for Criminal Conduct*

- a. The sanctions for criminal conduct include death, fine, imprisonment, removal from office, and removal of the right to vote.

- b. Criminal sanctions are set in place to protect the public, to bring justice to those who have been wronged, and to deter persons from wrongful conduct.

17. *Sanctions for Breach of Contract*

- a. Compensatory damages are designed to place the non-breaching party in the same position he or she would have been in had not the contract been breached.
- b. A remedy that orders the breaching party to perform the specific obligation under the contract.

18. *Sanctions for Tortious Conduct*

- a. The two premises of tort liability include intentional or negligent injury to others.
- b. Punitive damages are appropriate for intentional or willful and wanton injury.

19. *Sanctions for Violating Statutes and Regulations*

- a. The types of sanctions used for the violation of statutes and regulations include fines, imprisonment, injunction, and damages.
- b. An injunction is an order of the court to do something or to refrain from doing something.

Property and Corporate Governance

20. *The Specific Sense of Corporate Governance*

- a. In a “specific” sense, corporate governance refers to the rules regulating the legal relationship between corporate shareholders and corporate agents like the board of directors and senior executive managers.
- b. Some managers try to artificially raise or “puff up” the market price of their stocks to raise their incomes by millions of dollars even as they mislead the owners about the true value of the corporation and risk corporate collapse when the true situation is disclosed. Other ways include managers’ engaging in insider trading of stock, running up stock prices to exercise stock options, and taking advantage of business opportunities that rightfully belong to the corporation and its shareholders.

21. *The General Sense of Corporate Governance*

- a. In a “general” sense, corporate governance refers to the regulation of business activities as they might harm public resources like the air and water or the private resources of others.
- b. Effective corporate governance contributes to the creation of economic wealth by encouraging investment in corporate ownership, although corporate owners have little

control over corporate assets.

Business Discussion #1

1. *Do you know everything you need to make an investment decision?*

No, there is a lack of fundamental information critical to understanding the risk and likely chance of success if the company invests in China. How will the investment profits be taxed, how will the state protect resources, will the state expropriate the investment, is there adequate enforcement of contracts? Law is the foundation of private enterprise in the modern nation because if law and its enforcement is inadequate, the risks of doing business are too great.

2. *If not, what else do you need to know about investment in foreign countries?*

One needs to understand whether the country has legal institutions conducive to successful business investment, such as whether the country has adequately enforced legal fences that will protect what one needs, including the actions one must take, to do business successfully.

3. *What does it mean to say that law is the foundation of the private enterprise system?*

It means that the private market in modern nations depends on the state's protection of privately owned resources (property system) through the adequate enforcement of resource exchanges (contract), criminal laws against theft and fraud, and compensation for wrongful injuries to resources (tort law). Just compensation for state expropriation of an owner's resources is also a necessary foundation to give incentive for maximum investment and production in private enterprise.

Business Discussion #2

1. *What is law?*

Law is a series of rules enforced by the state. In a democracy, it will have a moral basis.

2. *What does it mean to say that Darden has "property" in the land? That the hunter has "property" in himself?*

The essence of property is the right to exclude others, including the state itself. Infringements on (or trespass to) an owner's land can lead to compensation or punishment. In the broad, Madisonian sense of property, the same analysis applies to the hunter's "ownership" of himself. Discuss this concept of self-ownership with the students. Just because people cannot sell themselves into slavery does not mean that people have no property in themselves or that people cannot sell their services, give away a kidney, or

exclude others from infringing on them.

3. *What sources of law will the attorney have to understand in order to advise Darden about the proposed greenway? The company's potential responsibility to the hunter?*

Discuss the section on constitutional law. Mention eminent domain, just compensation, and reference Chapter 7 (Property) and Chapter 10 (Torts). It must be pointed out to the students that being a trespasser does not free Darden Corporation from its responsibility not to harm individuals.