



# Unit 1 Tutorials: Essential Legal Concepts

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# What Is Law?

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the definition and prominent theories of law in the United States. Specifically, this lesson will cover:

### 1. Nature of Law

### 2. Theories of Law

#### 2a. Law as Power

#### 2b. Legal Positivism

#### 2c. Legal Realism

#### 2d. Natural Law

## 1. Nature of Law

If you were asked to define **law**, what would you say? Is “You should eat five fruits and vegetables a day” a law? Obviously not, so what distinguishes law from mere suggestions or good advice?

The key difference is enforcement and consequence. If you don’t eat five fruits and vegetables a day, you are not going to be imprisoned or fined. If you steal or embezzle, however, you may be prosecuted and face stiff financial penalties and imprisonment. Law, therefore, is a set of rules that are enforced by a government authority.

Now consider the nature of law.



### THINK ABOUT IT

Would you say that the law includes only the actual words that are written, or does it also include reading between the lines to discern the spirit of the law? Would you follow a law that you disagreed with, or would you ignore such a law? Do you believe that what the law actually is matters as much as who enforces it? Do you think that morality is a part of legality, or do you think that morality is wholly separate from the law?

Based on the particular **jurisprudence**, or philosophy of law, to which one ascribes, these questions will generate different answers. Not only will the answers to these questions differ, but the potential outcomes of

legal disputes can also vary widely, depending on one's conception of what the law is. These differences highlight fundamental disagreements over the nature of law.



#### TERMS TO KNOW

##### Law

A set of rules that are enforced by a government authority.

##### Jurisprudence

The philosophy, science, or study of law.

## 2. Theories of Law

The nature of law has been debated for centuries, giving rise to a general coalescence of ideas to create particular schools of thought. Each theory can inform our understanding of legal issues by allowing us to see the same thing from many different perspectives.

Moreover, depending on the philosophical perspective, there may be several possible outcomes to the same legal dispute that are equally supportable. This understanding can help you identify common ground among disputants as well as points of departure in their reasoning.

### 2a. Law as Power

At a most basic interpretation, some believe that law is simply power. That is, the law is followed because the sovereign issues orders that are backed by threats.

#### IN CONTEXT

Consider tyrannical rulers who create arbitrary laws or bad laws. If the sovereign has the power to enforce those laws, then regardless of the “badness” of the law, it is still the law. The Nazis executed six million Jews pursuant to German law during World War II. Saddam Hussein routinely tortured and executed political opponents and minority Sunni Muslims in Iraq under Iraqi law. The military in Myanmar (known euphemistically as the State Peace and Development Council) imprisoned the democratically elected and Nobel Peace Prize-winning prime minister of the country, Aung San Suu Kyi, under **color of law**. Those who ascribe to the idea that law is power often argue that coercion is an essential and necessary feature of law.

Many have criticized the understanding of law as nothing more than power backed by threats.

⇒ **EXAMPLE** Some point out that if law is nothing more than power, then the subjects of the law are simply at the mercy of whoever is in power. If we look at the U.S. system of government, however, citizens generally do not feel that they are “at the mercy” of the government. This is because people also have

power. People can elect their government officials, and they can "vote out" government officials who aren't doing a good job. In this way, those in power are accountable to the people.

Other criticisms include the more piercing observation that not all law requires the exercise or threat of overt power.

⇒ **EXAMPLE** Many of our laws rely on economic incentives, rather than force of power, to encourage compliance. Though penalty provisions may exist for violating those laws, those penalties may not be driving compliance itself.



#### TERM TO KNOW

##### Color of Law

The appearance of a legal right, without the substance; when a state actor takes illegal action, abusing power, but is clothed with the authority of the state.

## 2b. Legal Positivism

A competing view is that of **legal positivism**, whose proponents disagree that law is simply power. Instead, they believe that the law is what the law says. Laws are written, human-made rules, so they are not drawn from any source higher than humankind.

Legal positivists do not try to read between the lines. They may disagree with the law as it is written, but they will acquiesce to the sovereign power and follow the law as it is written. They reject any belief that they have an individual right to disobey a law that they happen to oppose, providing that the law is from a legitimate source.

Positivists also believe that law is wholly separate from any consideration of ethics. Moreover, they do not believe that people have intrinsic human rights other than those created by the law. This is very different from a natural rights perspective, which is discussed later.

Positivists differ from those holding the view that law is simply power because positivists believe that valid law must be created pursuant to the existing rules that allow the sovereign to create law. Under this way of thinking, an arbitrary declaration of law by a sovereign who did not follow the rules for creating the law would not be viewed as valid law. Additionally, positivists would not consider any rule or "law" created by an illegitimate ruler as valid law. Consequently, a legal positivist would feel no need to obey an illegitimately created "law."

⇒ **EXAMPLE** Consider the draft. Some people have a strong moral objection to engaging in armed conflict with other human beings. However, a legal positivist would most certainly comply with a law that required compulsory conscription, though he or she might use other legal channels to try to change the law.

A common criticism of legal positivism is that it prohibits individuals from remaining true to their own consciences when their consciences conflict with the laws of the sovereign. However, for a positivist, the desirability of enacting a law that might be viewed as "good" or "bad" is not relevant for determining what the law is. Some critics also point out that legal positivism is too limited in its conception of law.

⇒ **EXAMPLE** At least some laws seem to reflect a moral stance. The prohibition of insider trading (using nonpublic information to buy or sell a stock to make money) might be said to encompass the idea of fairness, which is a moral consideration. Likewise, **due process** (fundamental fairness and decency in

government actions) might be said to encompass the ideas of both fairness and a moral position against cruelty.

Moreover, not all law is the result of a sovereign-issued, written rule.

⇒ **EXAMPLE** International customary law has developed through customary practices. It is valid law, but it is not a set of rules handed down from a sovereign ruler.



#### TERMS TO KNOW

##### **Legal Positivism**

A system of jurisprudence that holds that law is socially constructed based on norms of society. It can be contrasted with a system such as natural law, which believes laws are based on morals that are unchanging and determined by nature, not man-made.

##### **Due Process**

Legal proceedings that are regular, orderly, and based on established principles for the enforcement and protection of rights.

## **2c. Legal Realism**

Another viewpoint is **legal realism**, which is the belief that the law itself is far less important than the consideration of who is in the position to enforce the law. Like positivists, legal realists believe that law is the product of human making. However, unlike positivists, they believe that the outcome of any issue that arises under law is dependent on the person, such as a judge, who is in the position to exercise power under the mantle of the law.

Additionally, realists believe that social and economic considerations should be brought to bear in legal disputes, which may very well be “extra” considerations that are not captured by the written law itself.

#### **IN CONTEXT**

If a realist brought a dispute before a particular judge who was known to be unsympathetic to that particular type of dispute, the realist would believe that the judge’s decision would reflect that leaning. For example, if a dispute arose under the Clean Water Act, and the defendant was a legal realist who believed that the judge was unduly harsh with environmental offenders, the legal realist would not look to the actual words of the Clean Water Act itself to determine a likely outcome. Instead, the defendant would view the judge’s personal and professional beliefs about water pollution as determinative factors. Moreover, if the plaintiff in the same case were a realist who did not believe that the Clean Water Act was very strong, that plaintiff might hope that the judge would consider the social importance of clean water to human health, natural environment, and animals.

Critics of legal realism point out that those who are in the position to exercise the power of the law over others should not circumscribe the checks and balances of our system of government by considering factors outside of legitimate sources of law when making decisions.

⇒ **EXAMPLE** Critics argue that judges should not use any factors other than the written law when rendering decisions. Legal realists, however, point out that judicial interpretation is not only necessary but was also considered by our Founding Fathers as a built-in check and balance to our other branches of government.



#### TERM TO KNOW

##### Legal Realism

A system of jurisprudence that holds that law is constructed by law makers (courts and legislatures) for the good of society and does not come from any supernatural source..

## 2d. Natural Law

**Natural law** is the idea that humans possess certain inalienable rights that are not the products of human-made law. Therefore, we can say that natural law differs from both positivism and realism in this important respect. Humans are able to reason, and therefore they are able to discover moral truths on their own. They are not automatons who require a sovereign power to tell them right from wrong.

Natural law adherents do not reject human-made law. However, they recognize that human-made law is subordinate to natural law if the two types of law conflict.

Civil rights activists often rely on natural law arguments to advance their platforms. This is true today as well as historically.

⇒ **EXAMPLE** A civil rights advocate might point out that regardless of what the law “says,” discrimination based on race is simply wrong. If the written law allowed racial discrimination, natural law adherents would not recognize the law as valid.



#### TERM TO KNOW

##### Natural Law

A system of jurisprudence that holds that law is based on a body of unchanging principles brought forth by the nature of human beings and their environment.



#### SUMMARY

In this lesson, you learned that the **nature of law** has been the subject of many disagreements because a person's interpretation of the law is often determined by which of the **theories of law** that person subscribes to. These theories include **law as power**, **legal positivism**, **legal realism**, and **natural law**. Understanding these different theories can help you find common ground between parties in a conflict, as well as recognize where their viewpoints differ.

Best of luck in your learning!

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## TERMS TO KNOW

### **Color of Law**

The appearance of a legal right, without the substance; when a state actor takes illegal action, abusing power, but is clothed with the authority of the state.

### **Due Process**

Legal proceedings that are regular, orderly, and based on established principles for the enforcement and protection of rights.

### **Jurisprudence**

The philosophy, science, or study of law.

### **Law**

A set of rules that are enforced by a government authority.

### **Legal Positivism**

A system of jurisprudence that holds that law is socially constructed based on norms of society. It can be contrasted with a system such as natural law, which believes laws are based on morals that are unchanging and determined by nature, not man-made.

### **Legal Realism**

A system of jurisprudence that holds that law is constructed by law makers (courts and legislatures) for the good of society and does not come from any supernatural source.

### **Natural Law**

A system of jurisprudence that holds that law is based on a body of unchanging principles brought forth by the nature of human beings and their environment.

# Law in Business

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the role of law in business settings. Specifically, this lesson will cover:

### 1. The Law in Business Disciplines

#### 1a. Accounting

#### 1b. Finance

#### 1c. Management

#### 1d. Marketing

## 1. The Law in Business Disciplines

Foundational courses taken by undergraduate business students usually include accounting, finance, management, and marketing. An understanding of the legal environment of business is relevant - indeed, essential - to functioning well within each of those disciplines.

Additionally, a solid understanding of the legal environment can help avoid liability or at least minimize risk. In business, it is not enough to conduct yourself and your business ethically. You must also ensure that you understand the legal environment in which you are working.

Therefore, it is important to you, to your employer, and to all the other people who may be relying on your business expertise - such as your employees and your family - to understand the legal environment. Such an understanding will help you avoid or lessen the likelihood of liability exposure, enabling you to manage your business affairs successfully, unhampered by unmanaged legal liability risks.

The following sections provide some examples of how law affects specific business disciplines. Of course, this is just an overview. It is the responsibility of each business professional to become familiar with the legal environment in his or her profession.

### 1a. Accounting

During the last several years, accountants have been in the spotlight due to culpable behavior of some members of the profession during well-known business scandals, such as the Enron case.



## IN CONTEXT

Largely as a result of the fallout from the Enron case, Congress passed the Sarbanes-Oxley Act (SOX) of 2002, which imposed stringent oversight requirements on accounting and auditing firms. The requirements seek to ensure competence, compliance with security laws, and conduct consistent with generally accepted accounting principles.

Of course, the Enron scandal and SOX are both fairly dramatic examples of how law can affect accounting. Other ways in which law affects this discipline occur through regulation.

⇒ **EXAMPLE** The U.S. Securities and Exchange Commission's (SEC) mission is to protect investors and to maintain a fair market, among other things. Accordingly, the SEC enforces accounting and auditing policies to allow investors to make decisions based on accurate information. The SEC pursues charges of accounting fraud and oversees private regulation of the accounting profession.

### 1b. Finance

Like accounting professionals, many who work in finance are also regulated by the SEC. The SEC aims to ensure that investors receive accurate information to make investment decisions. Moreover, the SEC enforces prohibitions against insider trading and pursues claims of other types of securities fraud, such as Ponzi schemes.

There are several statutes that protect consumers in financial transactions.

⇒ **EXAMPLE** The Truth in Lending Act (TILA) requires lenders to accurately provide information concerning the costs involved in offers of credit. TILA and its corresponding Regulation Z are administered by federal banking agencies.

### 1c. Management

Law also affects those in management.

⇒ **EXAMPLE** Knowledge of employment law is essential to professionals who work in human resources. Title VII of the Civil Rights Act prohibits discrimination related to protected characteristics in hiring and employment practices.

Those in management also must be aware of the potential liability that demands on employees might create.

## IN CONTEXT

In Oregon, McDonald's was found to be liable for injuries resulting when an off-duty, off-premises worker fell asleep while driving. The employee had worked three shifts during a twenty-four-hour period. The court held that employers have a duty to avoid conduct that creates a foreseeable risk of harm to others.

*Faverty v. McDonald's, 892 P.2d 703 (Or. Ct. App. 1995).*

## 1d. Marketing

If your field is marketing, the law also relates to your work. Marketers must be particularly attuned to tort law, consumer protection law, and intellectual property law.

⇒ **EXAMPLE** To avoid charges of libel, those in advertising need to take care not to defame another person, business, or product. It might be tempting to do so, especially if you are engaged in serious competition with another company that sells a similar product.

Likewise, marketers must take great care not to engage in deceptive advertising practices, lest their employer run afoul of the Federal Trade Commission's (FTC) policies or the FTC Act.

Additionally, marketers must be aware of other people's intellectual property to avoid copyright or trademark infringement in their own work product.



### SUMMARY

In this lesson, you learned about the role of **the law in business disciplines**. While the law is relevant to every business discipline, this lesson specifically focused on its role in **accounting, finance, management, and marketing**. Minimizing liability exposure is a primary concern of business, and an understanding of the legal environment relevant to each disciplinary perspective helps business practitioners minimize their risk of incurring liability to themselves or to their employers.

Best of luck in your learning!

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# U.S. Positive Law

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about some of the basic concepts and distinctions in United States positive law. Specifically, this lesson will cover:

1. Moral Minimums in a Democratic Society
2. Common Law
  - 2a. Property Law
  - 2b. Contract Law
  - 2c. Tort Law
3. State Courts and the Domain of State Law
4. Civil vs. Criminal Cases

## 1. Moral Minimums in a Democratic Society

Most of what we discuss here is **positive law**— U.S. positive law in particular. The term positive law simply refers to a body of man-made laws that regulate conduct.

However, the law does not correct (or claim to correct) every wrong that occurs in society. At a minimum, it aims to curb the worst kind of wrongs— the kind of wrongs that violate what might be called the moral minimums that a community demands of its members. These include not only violations of criminal law, but also torts and broken promises.

⇒ **EXAMPLE** It may be wrong to refuse to return a phone call from a friend, but that wrong will not result in a viable lawsuit against you. But if a phone (or the Internet) is used to libel or slander someone, a tort has been committed, and the law may allow the defamed person to be compensated.

There is a strong association between what we generally think of as ethical behavior and what the laws require and provide.

⇒ **EXAMPLE** Contract law upholds society's sense that promises - in general - should be kept. Promise-breaking is seen as unethical. The law provides remedies for broken promises (in breach of contract cases), but not for all broken promises; some excuses are accepted when it is reasonable to do so.

For tort law, harming others is considered unethical. If people are not restrained by law from harming one another, orderly society would be undone, leading to anarchy. Tort law provides for compensation when serious

injuries or harms occur.

As for property law issues, we generally believe that private ownership of property is socially useful and generally desirable, and it is generally protected (with some exceptions) by laws.

⇒ **EXAMPLE** You obviously can't throw a party at someone's house without permission, but your right to do whatever you want on your own property may also be limited by law. You can't, without the public's permission, operate an incinerator on your property and burn heavy metals, as toxic ash may be deposited throughout the neighborhood.



#### TERM TO KNOW

##### **Positive Law**

A body of human-made laws that regulate conduct.

## 2. Common Law

Even before legislatures met to make rules for society, disputes happened and judges decided them.

#### IN CONTEXT

In England, judges began writing down the facts of a case and the reasons for their decision. They often resorted to deciding cases on the basis of prior written decisions. In relying on those prior decisions, the judge would reason that since a current case was pretty much like a prior case, it ought to be decided the same way. This is essentially reasoning by analogy. Thus the use of precedent in **common law** cases came into being, and a doctrine of **stare decisis** (pronounced STAR-ay-de-SIGH-sus) became accepted in English courts. *Stare decisis* means, in Latin, “let the decision stand.”

The thirteen original colonies had been using English common law for many years, and they continued to do so after independence from England. Early cases from the first states are full of references to already-decided English cases. As years went by, many precedents were established by U.S. state courts, so that today a judicial opinion that refers to a seventeenth- or eighteenth-century English common-law case is quite rare.

Courts in one state may look to common law decisions from the courts of other states where the reasoning in a similar case is persuasive. This will happen in “cases of first impression,” a fact pattern or situation that the courts in one state have never seen before. But if the Supreme Court in a particular state has already ruled on a certain kind of case, lower courts in that state will always follow the rule set forth by their highest court.

Most judicial decisions that don't apply legislative acts (known as **statutes**) will involve one of three areas of law:

- Property

- Contract
- Tort



## TERMS TO KNOW

### Common Law

Court-created law; the body of court decisions creating precedents by which future cases will also be decided.

### Stare Decisis

Latin term referring to the doctrine courts apply to case law to adhere to precedents; to follow rules made by prior decisions and not to unsettle things that have already been established.

### Statute

An act of a legislature declaring, requiring, or prohibiting something. Also known as a law.

## 2a. Property Law

Property law deals with the rights and duties of those who can legally own land (real property), how that ownership can be legally confirmed and protected, how property can be bought and sold, what the rights of tenants (renters) are, and what the various kinds of “estates” in land are (e.g., fee simple, life estate, future interest, easements, or rights of way).

## 2b. Contract Law

Contract law deals with what kinds of promises courts should enforce.

⇒ **EXAMPLE** Should courts enforce a contract where one of the parties was intoxicated, underage, or insane? Should courts enforce a contract where one of the parties seemed to have an unfair advantage? What kind of contracts would have to be in writing to be enforced by courts?

## 2c. Tort Law

Tort law deals with the types of cases that involve some kind of harm and/or injury between the plaintiff and the defendant when no contract exists. Thus if you are libeled or a competitor lies about your product, your remedy would be in tort, not contract law.

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# 3. State Courts and the Domain of State Law

In the early years of our nation, federal courts were not as active or important as state courts. States had **jurisdiction** (the power to make and enforce laws) over the most important aspects of business life.

The power of state law has historically included governing the following kinds of issues and claims:

- Contracts
- Torts

- Property
- Corporations
- Partnerships
- Domestic matters
- Agency law
- Insurance

Over the past eighty years, however, federal law has become increasingly important in many other areas, including banking, securities, and environmental law.



#### TERM TO KNOW

##### Jurisdiction

A general term referring to the power and authority of a court; areas of authority including geographical areas covered by a court as well as subject matter areas and the ability to determine personal rights.

## 4. Civil vs. Criminal Cases

Most of the cases we will look at in this course are civil cases; however, criminal cases are certainly of interest to business, especially as companies may break criminal laws. A criminal case involves a governmental decision - whether state or federal - to prosecute someone (named as a defendant) for violating society's laws.

The law establishes a moral minimum and does so especially in the area of criminal laws; if you break a criminal law, you can lose your freedom or your life (if you are convicted of a capital offense). In a civil action, you would not be sent to prison; in the worst case, you can lose property, such as money or other assets.

⇒ **EXAMPLE** Ford Motor Company lost a personal injury case, and the judge awarded \$295 million to the plaintiffs.

Some of the basic differences between civil law and criminal law cases are illustrated in the following table.

Case Component	Civil Cases	Criminal Cases
<i>Parties</i>	Plaintiff brings case; defendant must answer or lose by default	Prosecutor brings case; defendant may remain silent
<i>Proof</i>	Preponderance of evidence	Beyond a reasonable doubt
<i>Reason</i>	To settle disputes peacefully, usually between private parties	To maintain order in society
<i>Remedies</i>	Money damages (legal remedy) Injunctions (equitable remedy) Specific performance (equity)	Fines, jail, and forfeitures

Regarding plaintiffs and prosecutors, you can often tell a civil case from a criminal case by looking at the caption of a case going to trial. If the government appears first in the caption of the case (e.g., *U.S. v. Lieberman*), it is likely that the United States is prosecuting on behalf of the people.

The same is true of cases prosecuted by state district attorneys (e.g., *State v. Seidel*). But this is not a foolproof formula. Governments will also bring civil actions to collect debts from or settle disputes with individuals, corporations, or other governments.

Governments can be sued, as well; people occasionally sue their state or federal government, but they can only get a trial if the government waives its sovereign immunity and allows such suits.



## SUMMARY

In this lesson, you learned that the law aims to cover **society's moral minimums**, but cannot account for all wrongs that may occur. In the United States, there is a fairly firm distinction between **criminal law** (for actions that are offenses against the entire society) and **civil law** (usually for disputes between individuals or corporations).

Basic ethical norms for promise-keeping and not harming others are reflected in the **common law** of **contracts**, **torts**, and **property**. Both the states and the federal government have roles to play, and sometimes these roles will overlap with standards set in both **state courts** and federal courts.

Best of luck in your learning!

Source: This content has been adapted from Lumen Learning's "U.S. Positive Law" tutorial.



## TERMS TO KNOW

### Common Law

Court-created law; the body of court decisions creating precedents by which future cases will also be decided.

### Jurisdiction

A general term referring to the power and authority of a court; areas of authority including geographical areas covered by a court as well as subject matter areas and the ability to determine personal rights.

### Positive Law

A body of human-made laws that regulate conduct.

### Stare Decisis

Latin term referring to the doctrine courts apply to case law to adhere to precedents; to follow rules made by prior decisions and not to unsettle things that have already been established.

### Statute

An act of a legislature declaring, requiring, or prohibiting something. Also known as a law.



# Origins of Law

by Sophia



## WHAT'S COVERED

In this lesson, you will become familiar with the primary sources of law in the United States. Specifically, this lesson will cover:

1. Law vs. Social Customs
2. Public vs. Private Law
3. Procedural vs. Substantive Law
  - 3a Substantive Law
  - 3b. Procedural Law

## 1. Law vs. Social Customs

Where does the law come from? How do you know right from wrong? Certainly your caretakers taught you right from wrong when you were a child. Your teachers, community elders, and other people who were in the position to help shape your ideas about appropriate manners of behavior also influenced your understanding of which behaviors are acceptable and which are not.

Additionally, employers often have very firm ideas about how their employees should conduct themselves. Those ideas may be conveyed through employers' codes of ethics, employee handbooks, or organizational cultures.

Of course, actions that are considered “wrong” and inappropriate behavior are not always violations of the law. They may simply represent social norms.

⇒ **EXAMPLE** It is generally not acceptable to ask strangers about their income. It is not illegal to do such a thing, but it is considered impolite. Imagine that you are interviewing for a position that you really want. Can you imagine yourself asking your potential employer how much money he or she makes? It would not be illegal for the employer to refuse to hire you based on your lack of social skills. However, it would be illegal for the employer not to hire you based solely on your race.

So what is the difference? One type of “right from wrong” is based on societal norms and cultural expectations. The other type of “right from wrong” is based on a source recognized as holding legitimate authority to make, and enforce, law within our society.

Someone may choose to ignore social customs, and there are usually negative social or professional consequences to doing so. A person who violates social customs may be considered a boor, or people may try to avoid that person because his or her actions and comments make others uncomfortable. However, no legal repercussions follow the violation of social customs.

Violations of law are different. Violating the law carries penalties, such as liability or loss of liberty, depending on the type of violation. While we may generally decide whether or not to conform to social customs, we are compelled to obey the law under threat of penalty.

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## 2. Public vs. Private Law

Law can generally be classified as public law or private law. Public law applies to everyone. It is law that has been created by some legitimate authority with the power to create law, and it has been “handed down” to the people within its jurisdiction.

In the United States, the lawmaking authority itself is also subject to those laws, because no one is “above” the law. If the law is violated, penalties can be levied against the violator. These penalties are also “handed down” from some recognized source of authority, like the judiciary.

Of course, people in the United States may participate in many law-creating activities.

⇒ **EXAMPLE** People may vote in elections for legislators, who, in turn, create legislation. Likewise, if people have a legal claim, their case may be heard by the judiciary.

It’s important to note, however, that not all law is public law. Private law is typically understood to be law that is binding on specific parties.

⇒ **EXAMPLE** Parties to a contract are involved in a private law agreement. The terms of the contract apply to the parties of the contract, but not to anyone else. If the parties have a contract dispute, they will be able to use dispute-resolution methods to resolve it. This is because both parties of the contract recognize the judiciary as a legitimate authority that can resolve the contract dispute. However, regardless of the resolution, the terms of the contract and the remedy for breach will apply only to the parties of the contract and not to everyone else.

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## 3. Procedural vs. Substantive Law

Additionally, some law is procedural and some law is substantive. **Procedural law** describes the legal rules that must be followed. In other words, it details the process or rules that are legally required.

⇒ **EXAMPLE** The U.S. government must generally obtain a warrant before searching someone’s private home. If the process of obtaining the warrant is ignored or performed illegally, then procedural law has been violated.

**Substantive law** refers to the actual substance of the law or the merits of the claim, case, or action. Substantive law embodies the ideas of legal rights and duties, and is captured by our different sources of law, like statutes, the Constitution, or common law.

Let's look at these two types in a little more depth.



#### TERMS TO KNOW

##### **Substantive Law**

The part of law that defines, creates, and describes rights and duties (as opposed to the procedural laws that merely govern how substantive laws are enforced.)

##### **Procedural Law**

Also called adjective or remedial law, the rules that govern the method of enforcement of substantive law.

### **3a Substantive Law**

We are used to seeing laws as substantive; that is, there is some rule of conduct or behavior that is called for or some action that is proscribed (prohibited).

The substantive rules tell us how to act with one another and with the government.

#### **IN CONTEXT**

All of the following are substantive rules of law and provide a kind of command or direction to citizens:

1. Drive no more than fifty-five miles per hour where that speed limit is posted.
2. Do not conspire to fix prices with competitors in the U.S. market.
3. Do not falsely represent the curative effects of your over-the-counter herbal remedy.
4. Do not drive your motor vehicle through an intersection while a red traffic signal faces the direction you are coming from.
5. Do not discriminate against job applicants or employees on the basis of their race, sex, religion, or national origin.
6. Do not discharge certain pollutants into the river without first getting a discharge permit.

### **3b. Procedural Law**

In contrast, procedural laws are the rules of courts and administrative agencies. They tell us how to proceed if there is a substantive-law problem.

#### **IN CONTEXT**

If you drive fifty-three miles per hour in a forty mile-per-hour zone on Main Street on a Saturday night and get a ticket, you have broken a substantive rule of law (the posted speed limit). Just how and what gets decided in court is a matter of procedural law:

- Is the police officer's word final, or will you go before a judge?
- If so, who goes first, you or the officer?
- Do you have the right to be represented by legal counsel?
- Does the hearing or trial have to occur within a certain time period?
- How long can the state take to bring its case?
- What kinds of evidence will be relevant?

In the United States, all state procedural laws must be fair, since the due process clause of the Fourteenth Amendment directs that no state shall deprive any citizen of "life, liberty, or property," without due process of law. (The \$200 fine plus court costs is designed to deprive you of property - your money - if you violate the speed limit.)

Federal laws must also be fair, because the Fifth Amendment to the U.S. Constitution has the exact same due process language as the Fourteenth Amendment. This suggests that some laws are more powerful or important than others, which is true.



## SUMMARY

In this lesson, you learned that **the difference between the law and social customs** is that social customs often guide our ideas of right and wrong, but they are not enforceable by law. You also learned that **some laws are public**, meaning that they apply to everyone, and **some laws are private**, meaning that they apply only to specific parties. Likewise, there is an important **distinction between substantive and procedural laws**. Substantive laws dictate how we act with one another and with the government, while procedural laws refer to the rules of courts and administrative agencies.

Best of luck in your learning!

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## TERMS TO KNOW

**Procedural Law**

Also called adjective or remedial law, the rules that govern the method of enforcement of substantive law.

**Substantive Law**

The part of law that defines, creates, and describes rights and duties (as opposed to the procedural laws that merely govern how substantive laws are enforced.)

# U.S. Constitution as a Source of Law

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the role and components of the Constitution as a primary source of law in the United States. Specifically, this lesson will cover:

1. **Primary and Secondary Sources of Law**
2. **Power and Limitations of the Constitution**
3. **State Constitutions and Federalism**

## 1. Primary and Secondary Sources of Law

In the United States, our laws primarily come from:

- The U.S. Constitution and the state constitutions
- Statutory law from Congress, the state legislatures, and local legislative bodies
- Common law
- Administrative rules and regulations
- Executive orders and treaties

These are all **primary sources of law**. As is true in any democracy, U.S. law reflects the will of the people who vote for representatives to make the law. In this way, U.S. law is also a reflection of **public policy**.

**Secondary sources of law** include:

- **Restatements of the law**
- Law review and journal articles
- Uniform codes
- Treatises

These sources are created by legal scholars rather than by a recognized, legitimate law-creating authority. However, these sources are read by and often influence those who are in the position to create law.

## IN CONTEXT

Members of the **judiciary** may consult a restatement of law or law-review articles when making decisions. Likewise, state legislatures often adopt whole or parts of uniform acts, such as the **Uniform Commercial Code (UCC)**. When a body of secondary law is formally adopted by a legitimate lawmaking authority, then it becomes primary law. In this example, adoption of the UCC by a state legislature transforms the UCC from a secondary source of law (a model code) to a primary source of law in that state— namely, a statute.



#### TERMS TO KNOW

#### Primary Sources of Law

Sources of law issued by courts, legislatures, government agencies, and other sources that create law, including published court decisions, statutes, court rules, government agency decisions, and the like.

#### Secondary Sources of Law

Sources of law that are written by those who discuss the law that comes from primary sources.

#### Public Policy

Generally accepted principles, mostly unwritten, on which society generally agrees. Occasionally, a court will base a decision on public policy concerns rather than black letter law.

#### Restatements of the Law

Treatises on legal subject areas written by known legal scholars and published by the American Law Institute, containing a summary of primary sources of law for the purpose of stating the law in one volume. Although the restatements are a secondary source of law, they are so well-respected that courts and legal scholars view them almost as if they were primary source of law.

#### Judiciary

The branch of government responsible for courts; the judges on a court.

#### Uniform Commercial Code (UCC)

A uniform act relating to commercial law that has, over time, been adopted in all 50 states, the District of Columbia, and US territories. It is not a federal law, but its adoption throughout the US makes interstate commercial transactions harmonious, although not all states have adopted all parts of the UCC.

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## 2. Power and Limitations of the Constitution

The U.S. Constitution created the structure of our federal government. Among other things, it sets forth the three branches:

- Legislative branch
- Executive branch
- Judicial branch

It provides organizational and procedural requirements, defines the boundaries of each branch's jurisdiction, and creates "checks" on each branch by the other branches.

⇒ **EXAMPLE** In Article II, Section 2, the President is the Commander in Chief of the armed forces, but he does not have the power to declare war. That duty falls to Congress.

The first ten amendments to the U.S. Constitution are known as the Bill of Rights. Some of the Founding Fathers did not believe that a Bill of Rights was necessary because the power granted to the federal government by the U.S. Constitution was expressly limited.

Any powers not expressly granted to the federal government by the U.S. Constitution are reserved to the states. This means that if the U.S. Constitution does not state that one of the federal branches of government has jurisdiction over a particular area, then that area falls to the states to regulate.

Despite the limited power granted to the federal government by the U.S. Constitution, as a condition of ratification, many states insisted on a written Bill of Rights that preserved certain individual civil rights and liberties. Today, business entities (such as corporations) that are treated as legal persons under the law enjoy many (but not all) of these rights and liberties, just as if they were natural human beings.

⇒ **EXAMPLE** Corporations have First Amendment rights to political speech under the Supreme Court's decision in *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010), but they are not persons for purposes of voting.



#### TERMS TO KNOW

##### **Legislative Branch**

In the U.S., the legislative branch is known as the Congress and is composed of the House of Representatives, elected every 2 years, and the Senate, elected every 6 years (in staggered terms so that 1/3 of the body is elected every 2 years). The purpose of Congress is to pass federal laws.

##### **Executive Branch**

In the U.S., the executive branch is the US President, cabinet, and agencies, and staff. The purpose of the executive branch is to carry out all of the laws of Congress.

##### **Judicial Branch**

In the U.S., the judicial branch of government is the federal court system. Its purpose is to enforce the laws of Congress by addressing cases and controversies that come before it.

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## 3. State Constitutions and Federalism

Each state also has its own constitution, and those constitutions serve essentially the same function for each individual state government as the U.S. Constitution serves for the federal government. Specifically, they establish the limits of government power, create protections for fundamental rights, and establish the organization and duties of the different branches of government at the state level.



This dual system of government present in the United States is called **federalism**, which is a governance structure whereby the federal government and state governments coexist through a shared power scheme. State laws may not conflict with federal laws, including the U.S. Constitution. This is because the U.S. Constitution is the supreme law of the land.

Sometimes, students of U.S. law will question why the law is not uniform throughout the U.S., suggesting that this would be so much simpler than each state having different laws. This is a fair question, and the answer is complicated, based on the country's history of having fought the Revolutionary War against a tyrannical monarch for eight years, from 1775-1783, and based on the continuing advantages of federalism.

Among the benefits of federalism are:

1. The lack of centralized power, which is regarded as a protection against the danger of tyranny.
2. Increased citizen participation available when state and local governments have a strong role.
3. Increased efficiency since states are deemed better at solving local problems than a remote and out-of-touch federal bureaucracy.
4. Freedom of choice to live where one's beliefs and values are compatible with state laws.
5. The opportunity to try something out at the state level before implementing it nationwide.

The drawbacks of federalism are seen in disparities among states with respect to wealth, quality of education, availability of social services, and the inability of the federal government to address these problems. Today, at least three major governments thrive under a federalist system: Canada, the European Union, and the United States.



#### TERM TO KNOW

##### Federalism

The U.S. system of government whereby a separate federal sovereign, the federal government, exists simultaneously with individual, sovereign states as one political system.



#### SUMMARY

In this lesson, you learned that there are both **primary and secondary sources of law**. The U.S. Constitution - the supreme law of the land - is a primary source of law that provides the framework for the three branches of the federal government, the legislative, executive, and judicial branches, as well as a template for the many **state constitutions**.

**The Constitution has a great deal of power, but it also has several limitations.** The Bill of Rights comprised of the first 10 Amendments to the Constitution limits the powers of the federal and state governments to infringe on fundamental civil rights and liberties of the people. All powers not expressly granted to the federal government in the Constitution are reserved for the states. The **federalist system of government** provides for limited centralized power in a federal government, while states have additional and concurrent powers independent of federal control.

Best of luck in your learning!

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## TERMS TO KNOW

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### **Federalism**

The U.S. system of government whereby a separate federal sovereign, the federal government, exists simultaneously with individual, sovereign states as one political system.

### **Judicial Branch**

In the U.S., the judicial branch of government is the federal court system. Its purpose is to enforce the laws of Congress by addressing cases and controversies that come before it.

### **Judiciary**

The branch of government responsible for courts; the judges on a court.

### **Legislative Branch**

In the U.S., the legislative branch is known as the Congress and is composed of the House of Representatives, elected every 2 years, and the Senate, elected every 6 years (in staggered terms so that 1/3 of the body is elected every 2 years). The purpose of Congress is to pass federal laws.

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Generally accepted principles, mostly unwritten, on which society generally agrees. Occasionally, a court will base a decision on public policy concerns rather than black letter law.

### **Restatements of the Law**

Treatises on legal subject areas written by known legal scholars and published by the American Law Institute, containing a summary of primary sources of law for the purpose of stating the law in one volume. Although the restatements are a secondary source of law, they are so well-respected that courts and legal scholars view them almost as if they were primary source of law.

### **Secondary Sources of Law**

Sources of law that are written by those who discuss the law that comes from primary sources.

**Uniform Commercial Code (UCC)**

A uniform act relating to commercial law that has, over time, been adopted in all 50 states, the District of Columbia, and US territories. It is not a federal law, but its adoption throughout the US makes interstate commercial transactions harmonious, although not all states have adopted all parts of the UCC.

# Legislation and Other Sources of Law

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about additional sources of law in the United States outside of the Constitution. Specifically, this lesson will cover:

### 1. Statutory Law

#### 1a. Components of Congress

#### 1b. How a Bill Becomes a Law

#### 1c. Limitations of Congress

### 2. Common Law

### 3. Administrative Law

## 1. Statutory Law

**Statutory law** is law created by a legislative body. **Congress** is the legislative body at the federal level. The states also have legislative bodies, most of which are **bicameral**, like our federal system. The state legislatures' names vary by state.

⇒ **EXAMPLE** In Indiana, the legislature is known as the General Assembly. In North Dakota, it is the Legislative Assembly. In New York, it is called the Legislature. Nevertheless, their purposes are the same. They are the legislative branches of their respective state governments.



## TERMS TO KNOW

### Statutory Law

Law created by a legislative body.

### Congress

The legislative body at the federal level.

### Bicameral

Legislative bodies such as Congress in the U.S. and Parliament in the United Kingdom that have 2 separate chambers. In the U.S., these are the House of Representatives and the Senate.

### 1a. Components of Congress

Congress is composed of a Senate, with 100 members, and a House of Representatives, with 435 members. The forefathers who wrote the Constitution deliberated and argued over how to compose the legislature, and the result is a deliberative body that doesn't always respond quickly to the will of the majority.

Since population numbers from the census taken every ten years determine how many House seats a state receives, smaller states are sometimes disproportionately represented in the Senate.

⇒ **EXAMPLE** Alaska and Delaware have only one representative in the House, but each has two senators. Senators serve six-year terms, and members of the House of Representatives serve two-year terms. There are no **term limits** for either senators or members of the House.

One benefit of having no term limits is that institutional knowledge and wisdom can be carried forward in perpetuity. One drawback is that elected officials may hedge their votes on important issues in a calculated way, to ensure reelection. If term limits were imposed, then vote pandering would not be a problem, but the Congress would be forever laboring with inexperienced lawmakers.



#### TERM TO KNOW

##### Term Limit

A legal limitation to the number of terms a particular officeholder may serve in a particular public office.

## 1b. How a Bill Becomes a Law

A bill may be introduced in Congress through the Senate or through the House of Representatives. Both the House of Representatives and the Senate have many committees, and these are related to all areas under the purview of Congress to legislate.

After a bill is introduced, it is sent to an appropriate committee in the chamber of Congress where the bill originated. If the committee moves forward with the bill, it modifies the bill as it sees fit to do, and then it sends the bill to the house of origination (either the Senate or the House of Representatives) for a vote.

If the bill passes, then it is sent to the other house (again, either the Senate or the House of Representatives), where it undergoes the same process. If the other house votes to approve the bill, then the bill goes to the joint committee, which is composed of members of both the House of Representatives and the Senate, where final work is completed. After that, the bill is sent to Congress for a full vote. If the bill passes, it is sent to the President. If the President signs the bill, then it becomes a statute.

The President may veto a bill. A presidential veto is an executive “check” on the legislative body. However, if the president vetoes a bill, the legislature can override the veto by a supermajority vote of 2/3 of the House and the Senate. A congressional override is a legislative “check” on the executive branch. These checks are built into our U.S. Constitution.

## 1c. Limitations of Congress

Importantly, Congress may not act outside of its enumerated powers. Many people wrongfully believe that Congress can do anything. That is simply not true. Article I, Section 8, lists the enumerated powers of Congress.

Remember that any power not granted to the federal government by the U.S. Constitution is reserved to the states. This means that if Congress passed a law in an area that was actually reserved to the states to regulate, Congress would have acted outside the scope of its powers. If challenged, the law would be struck down by a court as unconstitutional.

As a practical matter, this means that many U.S. states have state laws that are very different from each other.

⇒ **EXAMPLE** In Oregon, certain terminally ill patients may legally commit suicide under the state's Death with Dignity Act. However, in many other states, such an act would be illegal.

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## 2. Common Law

**Common law** is a very powerful and pervasive source of law, but little understood. Common law is judge-made law. Common law is a feature of most countries previously colonized by Great Britain, where it originated.

In continental Europe, an alternative system called civil law developed, where judges do not have the power to create law through interpretation. In civil law jurisdictions, only the legislature may create law. A jurisdiction is an area where power may be exercised.

In a common law system, when an appellate court hears cases and writes opinions, rules of law are created, formed, and shaped. After a particular legal issue has been decided in a jurisdiction, there is a high probability that subsequent cases that present the same legal issue will use the same rule of law generated from already-decided cases regarding the same legal issue.

This policy is known as *stare decisis*, or "let the decision stand." This is how a **precedent** is formed, though precedents may shift or change over time. Precedents also may be entirely overturned, though that is rare. Precedents and *stare decisis* allow us to anticipate the behavior of others and to gauge the legality of our own actions.

**Legal reasoning** is used by attorneys to argue for a particular outcome in a case and by judges when rendering decisions. At its most basic form, legal reasoning involves first identifying the legal question, which is the issue in dispute. Then, the rule of law that applies to that issue is identified. The rule of law may be drawn from precedent, for example, or it may come from a statute or the Constitution.

The facts of the case are analyzed against the rule of law to reach a supportable conclusion. This method of legal reasoning is referred to as the F+ IRAC method, which is an acronym for facts, issue, rule, analysis, and conclusion.

Common law is also important in those many areas that are reserved to the states to regulate.

⇒ **EXAMPLE** A state may exercise its police powers to regulate the safety, health, and welfare of its citizens. The laws implemented in these areas may give rise to laws in divergent areas, such as property law (e.g., zoning regulations), so-called vice laws (e.g., restrictions on vice business activities in certain areas or during certain days), and domestic relations (e.g., laws relating to marriage and adoption).

It should be noted that precedents vary among different jurisdictions because precedents created by one jurisdiction are not binding in other jurisdictions.



#### TERMS TO KNOW

##### Common Law

Court-created law; the body of court decisions creating precedents by which future cases will also be decided.

##### Precedent

A previous decision made by a court that serves as a basis for decisions going forward. In future cases where the same or similar set of facts and legal issue are presented, the court will typically follow the precedent.

##### Legal Reasoning

Reasoning done using several methods, the most basic of which is the syllogism: A conclusion is drawn from the premises. The premises are the facts and the rule of law that applies to such facts. Together, they form a logical conclusion. Example: All motorists are required by the law to stop at the stop sign. Joe did not stop but drove straight through the stop sign. Therefore, Joe broke the law.

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## 3. Administrative Law

Finally, we consider one last vast source of law that comes from regulations put forth by the many governmental agencies that exist in state and federal governments. This body of law is known as **administrative law**.

Most administrative agencies are created by the legislature. At the federal level they are created by Congress, and at the state level they are created through the state legislative bodies. Administrative agencies may be thought of as a delegation of congressional authority to area experts in particular fields, so that those experts can engage in limited lawmaking, adjudicative procedures, and investigations within their particular purviews.

Laws made by administrative agencies are called rules or regulations. Administrative agencies are created by **enabling legislation**, which sets forth the agencies' jurisdictional boundaries, rule-making procedures, and other information relating to the agencies' scopes of power.

Enabling legislation simply means that the elected legislature (i.e., Congress) passes legislation enabling an executive agency to create rules and regulations that have the force of law, but the agency is never allowed to go beyond its original grant of power by the enabling legislation.

⇒ **EXAMPLE** Congress passed the Food, Drug, and Cosmetic Act and created the agency called the FDA, the Food and Drug Administration, which takes on the role of creating and enforcing regulations related only to food, drugs, and cosmetics. The FDA is authorized by Congress to make rules regarding controlled substances. Although the FDA officials are appointed, not elected, to their positions, Congress has delegated this authority to them, and is also empowered to remove such authority.



## TERMS TO KNOW

### Administrative Law

A body of laws put in place by unelected government officials, also known as rules and regulations by a government agency.

### Enabling Legislation

Acts of Congress that create administrative agencies (typically serving under the executive branch of government) to carry out laws passed by Congress. This type of legislation allows the agency to only act consistently with such power to make rules, laws, and decisions as granted by Congress in the enabling legislation.



## SUMMARY

In this lesson, you learned that **statutory law** is law that is created by a legislative body. At the federal level, this legislative body is Congress. The **components of Congress** include the Senate and House of Representatives. **A bill becomes a law** once it has passed through the Senate, House of Representatives, and Congress, and has received approval from the President. **Congress is limited** in its power when it comes to laws at the state level.

**Common law**, composed of the body of court decisions made by the judicial branch of government, also has the force of law, but generally, these decisions are only binding within the geographical jurisdiction they cover. **Administrative law** consists of rules and regulations enacted by government agencies, created by Congress at the federal level and state legislatures at the state level.

Best of luck in your learning!

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## TERMS TO KNOW

### Administrative Law

A body of laws put in place by unelected government officials, also known as rules and regulations by a government agency.

### Bicameral

Legislative bodies such as Congress in the U.S. and Parliament in the United Kingdom that have 2 separate chambers. In the U.S., these are the House of Representatives and the Senate.



**Common Law**

Court-created law; the body of court decisions creating precedents by which future cases will also be decided.

**Congress**

The legislative body at the federal level.

**Enabling Legislation**

Acts of Congress that create administrative agencies (typically serving under the executive branch of government) to carry out laws passed by Congress. This type of legislation allows the agency to only act consistently with such power to make rules, laws, and decisions as granted by Congress in the enabling legislation.

**Legal Reasoning**

Reasoning done using several methods, the most basic of which is the syllogism: A conclusion is drawn from the premises. The premises are the facts and the rule of law that applies to such facts. Together, they form a logical conclusion. Example: All motorists are required by the law to stop at the stop sign. Joe did not stop but drove straight through the stop sign. Therefore, Joe broke the law.

**Precedent**

A previous decision made by a court that serves as a basis for decisions going forward. In future cases where the same or similar set of facts and legal issue are presented, the court will typically follow the precedent.

**Statutory Law**

Law created by a legislative body.

**Term Limit**

A legal limitation to the number of terms a particular officeholder may serve in a particular public office.

# Business Organizations

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the important factors to consider when choosing an entity type for a business. Specifically, this lesson will cover:

1. Purpose of Businesses
2. Entity Choice
3. Types of Businesses

## 1. Purpose of Businesses

At its most fundamental level, a business exists to make a profit for its owners. In a capitalist market-driven economy, a business that fails to make a profit ultimately ceases to exist, overtaken by creditors and competitors. The need to make a profit is one truism that binds all businesses together, but beyond that, it's hard to draw generalizations about business operations.

The world of business is as varied as human experience itself, ranging from the neighborhood kids who shovel snow in the winter and sell lemonade in the summer, to the neighborhood pizza restaurant, to the small factory on the outskirts of town making machine tools, to the multinational **corporation** with hundreds of thousands of employees scattered throughout the globe.

Some businesses make things in factories (manufacturers), some businesses sell things that other businesses make (retailers or franchisees), and some businesses exist to help both the makers and sellers make and sell better (business consultants). Some businesses don't make things at all, and instead profit by selling their services (think of an accounting or law firm, a house painting company, or a hotel) or by lending money at a higher rate of interest than it can borrow.



### TERM TO KNOW

#### Corporation

A business that is chartered by state law and requires a uniform structure such as shareholders who elect a board of directors who then elect officers. Regular meetings of record are required. The owners of a corporation (shareholders) are not liable for the business. Only the corporation itself is liable for the business's debts and judgments.

## 2. Entity Choice

With this breadth and diversity, it's not surprising that there is no "one size fits all" approach to choosing a business organization.

When choosing which form of entity is best, business professionals must consider several factors:

1. They have to consider how much it costs to create the entity and how hard it is to create. Some entities are easy to create, while others are more complicated and have ongoing maintenance requirements that are important to consider.
2. They have to consider how easy it is for the business to continue if the founder dies, decides to retire, or decides to enter a new business altogether.
3. They have to consider how difficult it might be to raise money to grow or expand the business.
4. They have to consider what sort of managerial control they wish to keep on the business, and whether they are willing to cede control to outsiders.
5. They have to consider whether or not they wish to eventually expand ownership to members of the public.
6. They must give some thought to tax planning to minimize the taxes paid on earnings and income.
7. They have to consider whether or not they wish to protect their personal assets from claims against the business, a feature known as **limited liability**.

If you are ever in a position to start a new business venture, your focus is typically on growing revenue and cutting costs so that you can maximize profit. You may not be very concerned with entity choice at the outset, since so many other considerations are competing for your attention.

Once an entity choice is made, however, it is difficult (but not impossible) to change to another selection. Since entity choice can have a profound effect on these considerations, it is important to gain a basic understanding of the available choices so that you, the business professional, can focus on the business fundamentals rather than legal or accounting details.



### TERM TO KNOW

#### Limited Liability

A limitation on a person's financial liability. In business, this refers to a corporation or a limited liability company (LLC). When one of these entities is sued, the owners of the corporation (shareholders) or of the LLC (members) are typically not liable at all for the acts of the company and only their investment in the company is at stake, not their personal wealth.

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## 3. Types of Businesses

It's important to remember that choosing a business organization is different from what kind of business you run.

Some businesses are known as **franchises** because they operate under a license agreement (contract) whereby they agree to follow certain standards set by the **franchisor**, purchase their goods from the franchisor, and maybe share either a royalty fee or percentage of profits with the franchisor.

Franchises are a very common type of business (especially in the food and service industries), but there is no typical form of business for a franchise. Depending on the needs of the franchise owners, a franchise could be a **sole proprietorship**, a **partnership**, a **limited liability company (LLC)**, or a corporation.

Similarly, we sometimes refer to “nonprofit organizations,” such as universities or charities, as separate legal entities. Although they are nonprofit, some of these enterprises can be very large, with complex operations that spread across borders (for example, The Red Cross or Doctors Without Borders).

For tax purposes, nonprofits do not have to pay any taxes if they meet strict qualifications under IRS guidelines to become a “501(c)(3)” organization (named for the section of the Internal Revenue Code that grants nonprofit status), but from a legal perspective, these entities can also take on any number of forms, from sole proprietorships to corporations.



#### TERMS TO KNOW

##### Franchise

The owner of intellectual property (patents, licenses, trademarks, etc.) who offers to franchisees (individuals or businesses) the use of its protected business ideas to operate a commercial enterprise under the name and mark of the owner.

##### Franchisor

A company (such as McDonald’s) that enters into a contract with a franchisee (an individual or business) to use the franchisor’s intellectual property (patents, licenses, trademarks, etc.) and operate a business as part of the franchise (such as an individual McDonald’s restaurant).

##### Sole Proprietorship

A business that is owned by one individual alone. This business and the individual who owns the business are one and the same and there is no separation between them, and the owner is fully liable for the business.

##### Partnership

An unincorporated business formed by two or more individuals to make a profit.

##### Limited Liability Company (LLC)

A hybrid between a corporation and a partnership in that it is a separate entity but has fewer formalities than a corporation. It is a simpler form of entity than a corporation but also has limited liability of its owners like a corporation, and unlike a partnership. It can only be formed under state law.



#### SUMMARY

In this lesson, you learned that the basic **purpose of businesses** is to make a profit, but the organizational goals and output of businesses vary greatly. Therefore, **entity choice** should take into

account such considerations as cost, ownership, managerial control, legal protection, and taxes. You also learned that the **type of business** is different from the entity or organization of the business. For example, a franchise could be classified as a sole proprietorship, a partnership, a limited liability company (LLC), or a corporation, depending on the specific business needs.

Best of luck in your learning!

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## TERMS TO KNOW

### Corporation

A business that is chartered by state law and requires a uniform structure such as shareholders who elect a board of directors who then elect officers. Regular meetings of record are required. The owners of a corporation (shareholders) are not liable for the business. Only the corporation itself is liable for the business's debts and judgments.

### Franchise

The owner of intellectual property (patents, licenses, trademarks, etc.) who offers to franchisees (individuals or businesses) the use of its protected business ideas to operate a commercial enterprise under the name and mark of the owner.

### Franchisor

A company (such as McDonald's) that enters into a contract with a franchisee (an individual or business) to use the franchisor's intellectual property (patents, licenses, trademarks, etc.) and operate a business as part of the franchise (such as an individual McDonald's restaurant).

### Limited Liability

A limitation on a person's financial liability. In business, this refers to a corporation or a limited liability company (LLC). When one of these entities is sued, the owners of the corporation (shareholders) or of the LLC (members) are typically not liable at all for the acts of the company and only their investment in the company is at stake, not their personal wealth.

### Limited Liability Company (LLC)

A hybrid between a corporation and a partnership in that it is a separate entity but has fewer formalities than a corporation. It is a simpler form of entity than a corporation but also has limited liability of its owners like a corporation, and unlike a partnership. It can only be formed under state law.

### Partnership

An unincorporated business formed by two or more individuals to make a profit.

**Sole Proprietorship**

A business that is owned by one individual alone. This business and the individual who owns the business are one and the same and there is no separation between them, and the owner is fully liable for the business.

# Sole Proprietorships and Partnerships

by Sophia



## WHAT'S COVERED

In this lesson, you will look at three types of business entities through the lens of an example scenario. Specifically, this lesson will cover:

1. Sole Proprietorships
2. General Partnerships
  - 2a. Ending a General Partnership
3. Limited Partnerships

## 1. Sole Proprietorships

Let's assume that after her first summer running Lily's Landscaping, Lily decides that it's time to take her business to the next level. Currently, she is running her business as a **sole proprietorship**, which is the simplest type of business entity.

It consists of one owner, Lily, and, as the owner, Lily is responsible for every decision, reaps all of the profits and reports them on her individual tax return, and (here's the downside), she alone is responsible for all business debts and contracts. This means that she and the business are one and the same.

If the business incurs liability or debt, it will come out of Lily's personal assets. If the business is sued, it is sued in Lily's name, and she is solely liable for any judgments entered against the business. Many businesses start out as sole proprietorships and later grow into more complex entities.

Keep in mind that a sole proprietorship, however, is not always a tiny business. Many of them are large because the sole proprietorship can hire employees and operate under a registered fictitious name. Nevertheless, it is still solely run, owned, taxed, and sued in the name of the owner.



### TERM TO KNOW

#### Sole Proprietorship

A business that is owned by one individual alone. This business and the individual who owns the business are one and the same and there is no separation between them, and the owner is fully liable for the business.

## 2. General Partnerships

Back to Lily. She has gathered a lot of expertise in running the operations in her business, from placing orders with suppliers to scheduling workers for client projects.

She realizes, however, that she's not very good at marketing or accounting, and that if her business is to grow, she needs to bring someone on board who can create a strong brand and strategy for growth, as well as keep good records of her accounts so that she can plan for the future. Fortunately, her good friend Adam is a double major in accounting and marketing, and after a series of discussions, Adam and Lily decide to run Lily's Landscaping together.

Lily and Adam have formed a **general partnership**. The moment they agreed to run Lily's Landscaping together, and to share in the profits and losses of the business together, the partnership was formed. Although their partnership agreement is oral (not written), most general partnerships are formed formally, with partners writing down their agreement in a special type of contract known as a partnership agreement. This is not required, but certainly recommended.

In the absence of a formal agreement, they will still have a partnership. The agreement can set forth anything the partners wish to include about how the partnership will be run. Normally, all general partners have an equal voice in management, but they can modify this if they wish. As in a sole proprietorship, there is no state involvement in creating a general partnership because there is no separation between the business and the partners— they are legally the same.

A general partnership is taxed just like a sole proprietorship. The partnership is considered a disregarded entity for tax purposes, so income “flows through” the business to the partners, who then pay ordinary income tax on the business income. The partnership may file an information return, reporting total income and losses for the partnership, and how those profits and losses are allocated among the general partners.

It's been said that a business partnership is like a marriage, and the most important decision is to choose a trustworthy partner. This is because any action taken by one partner in a partnership is binding on all of the other partners, even if they did not all agree to the action.

This is considered one of the downsides to a partnership— full liability by all partners for any debts, judgments, contracts, or liabilities that befall the business. Creditors may collect against all partners or any one of them, including their personal assets. This is called **joint and several liability**.



### BIG IDEA

The simplicity and ease of formation of general partnerships make them attractive, but the unlimited liability of their owners makes them risky. Particularly in a partnership, this risk can fall on one partner who may be completely innocent of any wrongdoing and still be liable for another partner's malpractice or bad acts. The partnership agreement cannot alter this condition because it can only make agreements between partners, not the outside parties who sue the business.



### TERMS TO KNOW



## General Partnership

An unincorporated association formed by two or more individuals to carry on business, both of whom are personally liable for all debts of the partnership.

## Joint and Several Liability

Liability characterized by the ability of a creditor to sue one or all of the parties at the creditor's option.

## 2a. Ending a General Partnership

General partnerships are dissolved as easily as they are formed. To sell the partnership or to change the make-up of partners, the partnership is simply dissolved and a new partnership formed.

The assets from the first partnership are transferred to the new partnership. Unlike corporations, partnerships are not transferred with stock or shares. In a general partnership with more than two persons, the remaining partners can reconstitute the partnership if they wish, without the old partner.

A common issue that arises is how to value the withdrawing partner's share of the business. The partnership agreement will typically include a buy/sell provision, setting forth the agreement of the partners on how to account for a withdrawing partner's share, which the remaining partners then agree to pay to the withdrawing partner (or the spouse or heir if the partner dies).

### CASE STUDY: *Dawson v. White & Case*

After a nearly twenty-year career, Evan Dawson was a partner at a major New York City law firm, White & Case. In 1988, the firm tried to persuade him to withdraw as a partner, but he refused. In July of that year, the other partners in the firm voted to dissolve the partnership and then immediately re-formed again, without Dawson as a partner. He had effectively been fired as a partner from a general partnership. Dawson filed a suit against White & Case for an "accounting," claiming that the **goodwill** of the law firm should be part of the valuation of the partnership.

The common law in New York at the time was that professional partnerships like law firms have no goodwill. The reasoning behind the rule is that as professionals, law firm partners develop and cultivate their own goodwill with clients, and if a partner leaves the firm then the goodwill leaves with that partner. The New York Court of Appeals, in its opinion on this case, held that unless the partnership agreement states otherwise, goodwill is indeed an asset of the partnership and has to be distributed when the partnership is dissolved.

[You can access more details on the case here.](#)



### TERM TO KNOW

## Goodwill

In business, the intangible qualities of a business that give it a good reputation; goodwill is considered to have monetary value.

### 3. Limited Partnerships

Let's assume that the general partnership formed by Lily and Adam flourishes and becomes profitable. To grow the landscaping business, they want to bring in Lily's wealthy uncle as a partner.

The uncle, however, is worried about unlimited liability. In this case, they can form a **limited partnership**. A limited partnership has both general partners and at least one limited partner. In this case, Lily and Adam will remain as general partners in the business, but the uncle can become a limited partner and enjoy limited liability.

As a limited partner, the most he can lose is the amount of his investment into the business, nothing more. Limited partnerships have to be formed in compliance with state law, and limited partners are prohibited from participating in day-to-day management of the business.



#### TERM TO KNOW

##### Limited Partnership

An unincorporated association formed by two or more individuals to carry on business, and at least one partner is relieved of personal liability for the debts of the partnership, in compliance with special state laws that allow this. The limited partner's liability is limited to his or her investment in the partnership.



#### SUMMARY

In this lesson, you learned that a **sole proprietorship** is an individual owning and operating a business with no legal formalities, and a **general partnership** is formed when two or more persons agree to share profits and losses in a joint business venture. Sole proprietorships and general partnerships are not considered to be separate legal entities, and the owners have unlimited liability. **Ending a general partnership** involves transferring assets to a new partnership or redistributing them among the remaining partners. General partners can also bring in limited partners, creating a **limited partnership**. Limited partners enjoy limited liability, but cannot participate in day-to-day management of the business.

Best of luck in your learning!

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#### TERMS TO KNOW

**General Partnership**

An unincorporated association formed by two or more individuals to carry on business, both of whom are personally liable for all debts of the partnership.

**Goodwill**

In business, the intangible qualities of a business that give it a good reputation; goodwill is considered to have monetary value.

**Joint and Several Liability**

Liability characterized by the ability of a creditor to sue one or all of the parties at the creditor's option.

**Limited Partnership**

An unincorporated association formed by two or more individuals to carry on business, and at least one partner is relieved of personal liability for the debts of the partnership, in compliance with special state laws that allow this. The limited partner's liability is limited to his or her investment in the partnership.

**Sole Proprietorship**

A business that is owned by one individual alone. This business and the individual who owns the business are one and the same and there is no separation between them, and the owner is fully liable for the business.

# Corporations

by Sophia



## WHAT'S COVERED

In this lesson, you will take a closer look at the functions of a particular type of business entity. Specifically, this lesson will cover:

1. Purpose of Corporations
2. Formation of Corporations
3. Shareholders
4. Board of Directors
5. Corporate Officers
6. Applications of Corporate Law

## 1. Purpose of Corporations

So far, we have explored sole proprietorships and partnerships, two common and relatively painless ways for persons to conduct business operations. Both of these forms of business come with significant disadvantages, however, especially in the area of liability.

The idea that personal assets may be placed at risk by business debts and obligations is rightfully scary to most people. Businesses therefore need a form of business organization that provides limited liability to owners and is also flexible and easy to manage. That is where the modern **corporation** comes in.

### IN CONTEXT

Consider, for example, tech entrepreneur and Apple cofounder Steve Jobs. As a young man, he was a college dropout without much ability for computer engineering. If doing business as a sole proprietor was his only option, Apple would not exist today. However, Jobs met a talented computer engineer named Steve Wozniak, and the two decided to pool their talents to form Apple Computer in 1976. A year later, the company was incorporated, and in 1980 went public in an initial public offering (IPO).

Incorporation allowed Jobs much more flexibility in carrying out business operations than a mere sole proprietorship could have. It allowed him to bring in other individuals with distinct skills and

capabilities, raise money in the early stage of operations by promising shares in the new company, and eventually become very wealthy by selling stock, or securities, in the company

Unlike a sole proprietorship or general partnership, a corporation is a separate legal entity, distinct from its owners. It can be created for a limited duration, or it can have perpetual existence. Since it is a separate legal entity, a corporation has continuity regardless of its owners.

In addition to being somewhat cumbersome to manage, corporations possess one very unattractive feature for business owners: double taxation. Since corporations are separate legal entities, taxing authorities consider them as taxable persons, just like ordinary human beings.

A corporation doesn't have a Social Security number, but it does have an Employer Identification Numbers (EIN), which serves the same purpose of identifying the company to tax authorities. As a separate legal entity, corporations must pay federal, state, and local tax on net income (although the effective tax rate for most U.S. corporations is much lower than the top income tax rate). That same pile of profit is then subject to tax again when it is returned to shareholders as a dividend, in the form of a dividend tax.



#### TERM TO KNOW

##### **Corporation**

A business that is chartered by state law and requires a uniform structure such as shareholders who elect a board of directors who then elect officers. Regular meetings of record are required. The owners of a corporation (shareholders) are not liable for the business. Only the corporation itself is liable for the business's debts and judgments.

## 2. Formation of Corporations

Since corporations have a separate legal existence and have many legal and constitutional rights, they must be formed in compliance with corporate law.

Corporate law is state law, and corporations are incorporated by the states; there is no such thing as a "U.S. corporation." Most corporations incorporate where their principal place of business is located, but not all do.

#### IN CONTEXT

Many companies choose to incorporate in the tiny state of Delaware even though they have no business presence there, not even an office cubicle. Delaware chancery courts have developed a reputation for fairly and quickly applying a very well-developed body of corporate law. The courts also operate without a jury, meaning that disputes heard in Delaware courts are usually predictable and transparent, with well-written opinions explaining how the judges came to their conclusions.

Since corporations are created, or chartered, under state law, business founders must file articles of incorporation with their respective state agencies to start their companies. These agencies are typically located within the Secretary of State.

Articles of incorporation may vary from state to state but typically include a common set of questions:

1. The founders must state the name of the company and whether the company is for-profit or nonprofit. The name has to be unique and distinctive, and must typically include some form of the words “Incorporated,” “Company,” “Corporation,” or “Limited.”
2. The founders must state their identity, how long they wish the company to exist, and the company’s purpose.
3. The founders must also state how many shares the corporation will issue initially, and the par value of those shares. Of course, the company can issue more shares in the future or buy them back from shareholders.



#### DID YOU KNOW

Under older common law, shareholders could sue a company that conducted business beyond the scope of its articles (these actions are called *ultra vires*), but most modern statutes permit the articles to simply state the corporation can carry out “any lawful actions,” effectively rendering *ultra vires* lawsuits obsolete in the United States.

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## 3. Shareholders

Owners of companies are called **shareholders**. Corporations can have as few as one shareholder or as many as millions of shareholders, and those shareholders can hold as few as one share or as many as millions of shares.

In a closely held corporation, the number of shareholders tends to be small, while in a publicly traded corporation, the body of shareholders tends to be large. In a publicly traded corporation, the value of a share is determined by the laws of supply and demand, with various markets or exchanges providing trading space for buyers and sellers of certain shares to be traded. It’s important to note that shareholders own the share or stock in the company, but have no legal right to the company’s assets whatsoever. As a separate legal entity, the company owns the property.

Shareholders of a corporation enjoy limited liability. The most they can lose is the amount of their investment, which is whatever amount they paid for the shares of the company. If a company is unable to pay its debts or obligations, it may seek protection from creditors in bankruptcy court, in which case shareholders lose the value of their stock. Shareholders’ personal assets, however, such as their own homes or bank accounts, are not reachable by those creditors.

Shareholders can be human beings or can be other corporate entities, such as partnerships or corporations. If one corporation owns all the stock of another corporation, the owner is said to be a parent company, while the company being owned is a wholly owned subsidiary. A parent company that doesn’t own all the stock of another company might call that other company an affiliate instead of a subsidiary.

Many times, large corporations may form subsidiaries for specific purposes, so that the parent company can have limited liability or advantageous tax treatment.

⇒ **EXAMPLE** Large companies may form subsidiaries to hold real property so that premises liability is limited to that real estate subsidiary only, shielding the parent company and its assets from tort lawsuits.

You will learn more about torts and property in later lessons.

Companies that deal in a lot of intellectual property may form subsidiaries to hold their intellectual property, which is then licensed back to the parent company so that the parent company can deduct royalty payments for those licenses from its taxes. This type of sophisticated liability and tax planning makes the corporate form very attractive for larger business in the United States.



#### TERM TO KNOW

##### Shareholder

A human being or corporate entity that owns stock in a company but has no legal right to the company's assets.

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## 4. Board of Directors

One of the most important functions for shareholders is to elect the board of directors for a corporation. The board is responsible for making major decisions that affect a corporation, such as:

- Declaring and paying a corporate dividend to shareholders
- Authorizing major new decisions
- Appointing and removing corporate officers
- Determining employee compensation
- Issuing new shares and corporate bonds

Since the board doesn't meet that often, the board can delegate these tasks to committees, which then report to the board during board meetings.

Shareholders can elect anyone they want to a board of directors, up to the number of authorized board members as set forth in the corporate documents. Most large corporations have board members drawn from both inside and outside the company. Outside board members can be drawn from other private companies (but not competitors), former government officials, or academia.

It's not unusual for the chief executive officer (CEO) of the company to also serve as chair of the board of directors, although the recent trend has been toward appointing different persons to these functions. Many shareholders now actively vie for at least one board seat to represent the interests of shareholders, and some corporations with large labor forces reserve a board seat for a union representative.

Board members are given wide latitude to make business decisions that they believe are in the best interest of the company. Under the **business judgment rule**, board members are generally immune from any second-guessing of their decisions as long as they act in good faith and in the corporation's best interests. Board

members owe a **fiduciary** duty to the corporation and its shareholders, and therefore are presumed to be using their best business judgment when making decisions for the company.

Shareholders in derivative litigation can overcome the business judgment rule, however. Another fallout from corporate scandals has been increased attention to board members and holding them accountable for actually managing the corporation.

### IN CONTEXT

When WorldCom fell into bankruptcy as a result of reckless spending by its chief executive, board members were accused of negligently allowing the CEO to plunder corporate funds. Corporations pay for insurance for board members (known as D&O insurance, for directors and officers), but in some cases, D&O insurance doesn't apply, leaving board members to pay directly out of their own pockets when they are sued. In 2005, ten former outside directors for WorldCom agreed to pay \$18 million out of their own pockets to settle shareholder lawsuits.



### TERMS TO KNOW

#### Business Judgment Rule

A rule applied by courts that presumes that a business decision made by directors of a corporation is made in good faith that it is in the best interests of the company.

#### Fiduciary

The legal status of a person who is obligated to act in another's best interests, similar to a trustee, with a high degree of care, honesty, and trust.

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## 5. Corporate Officers

A critical job for a board of directors is to appoint corporate officers. These officers are also known as “C-level” executives and typically hold titles such as chief executive officer, chief operating officer, chief of staff, chief marketing officer, and so on.

Officers are involved in everyday decision making for the company and implementing the board's strategy into action. As officers of the company, they have legal authority to sign contracts on behalf of the corporation, binding the corporation to legal obligations. Officers are employees of the company and work full-time for the company, but can be removed by the board, typically without cause.

Directors and officers of corporations are also bound by fiduciary duty, or a high level of care and loyalty. They are obligated under the law to promote the best interests of the corporation and not do anything that goes against the corporation.

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## 6. Applications of Corporate Law

Corporate law is very flexible in the United States and can lead to creative solutions to business problems.

### IN CONTEXT

General Motors Corporation was a well-known American company that built a global automotive empire that reached virtually every corner of the world. In 2009, the General Motors Corporation faced an unprecedented threat from a collapsing auto market and a dramatic recession, and could no longer pay its suppliers and other creditors. The U.S. government agreed to inject funds into the operation but wanted the company to restructure its balance sheet at the same time so that those funds could one day be repaid to taxpayers. The solution? Form a new company, General Motors Company, or the “new GM.”

The old GM was brought into bankruptcy court, where a judge permitted the wholesale cancellations of many key contracts with suppliers, dealers, and employees that were costing GM a lot of money. Stock in the old GM became worthless. The old GM transferred all of GM’s best assets to the new GM, including the surviving brands of Cadillac, Chevrolet, Buick, and GMC; the plants and assets those brands rely on; and the shares in domestic and foreign subsidiaries that the new GM wanted to keep. The old GM (subsequently renamed “Motors Liquidation Company”) kept all the liabilities that no one wanted, including obsolete assets such as shuttered plants, as well as unpaid claims from creditors.

The U.S. federal government became the majority shareholder of General Motors Company until it sold the last of its shares of GM stock in 2013. Although GM paid back its loan from the U.S. Treasury, the government lost billions in bailing out this company. To the public, there is very little difference between the old and new GM. From a legal perspective, however, they are totally separate and distinct from each other.

One exception to the rule of limited liability arises in certain cases, mainly involving closely held corporations. Many sole proprietors incorporate their businesses to gain limited liability, but fail to realize when they do so that they are creating a separate legal entity that must be respected as such.

If sole proprietors fail to respect the legal corporation with an arm’s-length transaction, then creditors can ask a court to **pierce the corporate veil**. If a court agrees, then limited liability disappears and those creditors can reach the shareholder’s personal assets. Essentially, creditors are arguing that the corporate form is a sham to create limited liability and that the shareholder and the corporation are indistinguishable from each other, just like a sole proprietorship.

⇒ **EXAMPLE** If a business owner incorporates the business and then opens a bank account in the business name, the funds in that account must be used for business purposes only. If the business owner routinely “dips into” the bank account to fund personal expenses, then an argument for piercing the

corporate veil can be made. In addition, if a corporate officer, director, or shareholder is directly involved in wrongdoing, the corporate veil does not cover such liability.

Under most state laws, including Delaware's business laws, shareholders are also given a unique right to sue a third party on behalf of the corporation. This is called a **shareholder derivative lawsuit** (so called because the shareholder is suing on behalf of the corporation, having "derived" that right by virtue of being a shareholder). In essence, a shareholder is alleging in a derivative lawsuit that the people who are ordinarily charged with acting in the corporation's best interests (the officers and directors) are failing to do so, and therefore the shareholder must step in to protect the corporation.

These lawsuits are very controversial because they are typically litigated by plaintiffs' lawyers working on contingency fees and can be very expensive for the corporation to litigate. Executives also disfavor them because oftentimes, shareholders sue the corporate officers or directors themselves for failing to act in the company's best interest.



#### TERMS TO KNOW

##### Piercing the Corporate Veil

A judicial process in which a court disregards the protection from personal liability of a corporations' officers, directors, or shareholders when incorporation is viewed as solely for the purpose of perpetuating fraud.

##### Shareholder Derivative Lawsuit

A lawsuit brought by a shareholder on behalf of the corporation against a third party. Normally an officer would do this, but when he or she fails to take needed action, a shareholder may step in.



#### SUMMARY

In this lesson, you learned that the **purpose of corporations** as a form of business organization is to act as separate legal entities from their owners. The **formation of corporations** must occur in accordance with state law. Owners of corporations are known as **shareholders**. Shareholders of corporations have limited liability, but most are subject to double taxation of corporate profits. Shareholders elect a **board of directors**, which in turn appoints **corporate officers** to manage the company. Often, **corporate law can be applied** in ways that offer flexible solutions to business problems.

Best of luck in your learning!

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#### TERMS TO KNOW

**Business Judgment Rule**

A rule applied by courts that presumes that a business decision made by directors of a corporation is made in good faith that it is in the best interests of the company.

**Corporation**

A business that is chartered by state law and requires a uniform structure such as shareholders who elect a board of directors who then elect officers. Regular meetings of record are required. The owners of a corporation (shareholders) are not liable for the business. Only the corporation itself is liable for the business's debts and judgments.

**Fiduciary**

The legal status of a person who is obligated to act in another's best interests, similar to a trustee, with a high degree of care, honesty, and trust.

**Piercing the Corporate Veil**

A judicial process in which a court disregards the protection from personal liability of a corporations' officers, directors, or shareholders when incorporation is viewed as solely for the purpose of perpetuating fraud.

**Shareholder**

A human being or corporate entity that owns stock in a company but has no legal right to the company's assets.

**Shareholder Derivative Lawsuit**

A lawsuit brought by a shareholder on behalf of the corporation against a third party. Normally an officer would do this, but when he or she fails to take needed action, a shareholder may step in.

# Limited Liability Entities

by Sophia



## WHAT'S COVERED

In this lesson, you will take a closer look at the functions of a particular type of business entity. Specifically, this lesson will cover:

1. Purpose of Limited Liability Companies
2. Formation of Limited Liability Companies
3. Disadvantages of Limited Liability Companies
4. Limited Liability Partnerships

## 1. Purpose of Limited Liability Companies

By now you should understand how easy yet dangerous it is to do business as a sole proprietor, and why many business organizations are drawn to the corporation as a form for doing business.

As flexible as the corporation is, however, it is probably best suited for larger businesses. Annual meeting requirements, the need for directors and officers, and the unattractive taxation features make corporations unwieldy and expensive for smaller businesses. A form of business organization that provides the ease and simplicity of sole proprietorships, but the limited liability of corporations, would be much better suited for a wide range of business operations.

A **limited liability company (LLC)** is a good solution to this problem. LLCs are a “hybrid” form of business organization that offers the limited liability feature of corporations but the tax benefits of partnerships. Owners of LLCs are called members. Just like a sole proprietorship, it is possible to create an LLC with only one member. LLC members can be real persons or they can be other LLCs, corporations, or partnerships.

Taxation of LLCs is very flexible. Essentially, every tax year the LLC can choose how it wishes to be taxed. It may want to be taxed as a corporation, for example, and pay corporate income tax on net income. Or it may choose instead to have income “flow through” the corporate form to the members, who then pay personal income tax just as in a partnership. Sophisticated tax planning becomes possible with LLCs because tax treatment can vary by year.



### TERM TO KNOW

**Limited Liability Company (LLC)**

A hybrid between a corporation and a partnership in that it is a separate entity but has fewer formalities than a corporation. It is a simpler form of entity than a corporation but also has limited liability of its owners like a corporation, and unlike a partnership. It can only be formed under state law.

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## 2. Formation of Limited Liability Companies

LLCs are formed by filing the **articles of organization** with the state agency charged with chartering business entities, typically the Secretary of State. Starting an LLC is often easier than starting a corporation.

In fact, you might be startled at how easy it is to start an LLC; typical LLC statutes require only the name of the LLC and the contact information for the LLC's legal agent (in case someone decides to file a lawsuit against the LLC). In most states, forming an LLC can be done by any competent business professional without any legal assistance, for minimal time and cost.

Unlike corporations, there is no requirement for an LLC to issue stock certificates, maintain annual filings, elect a board of directors, hold shareholder meetings, appoint officers, or engage in any regular maintenance of the entity. Most states require LLCs to have the letters "LLC" or words "Limited Liability Company" in the official business name. Of course, LLCs can also file d.b.a. filings to assume another name.

Although the articles of organization are all that is necessary to start an LLC, it is advisable for the LLC members to enter into a written LLC **operating agreement**. The operating agreement typically sets forth how the business will be managed and operated. It may also contain a buy/sell agreement just like a partnership agreement.

The operating agreement allows members to run their LLCs any way they wish to, but it can also be a trap for the unwary. LLC law is relatively new compared to corporation law, so the absence of an operating agreement can make it very difficult to resolve disputes among members.



### TERMS TO KNOW

#### Articles of Organization

The state filing required to start an LLC. For corporations, these are called articles of incorporation.

#### Operating Agreement

The contract between members of an LLC.

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## 3. Disadvantages of Limited Liability Companies

LLCs are not without disadvantages. Since they are a separate legal entity from their members, members must take care to interact with LLCs at arm's length, because the risk of piercing the veil exists with LLCs as much as it does with corporations.

Fundraising for an LLC can be as difficult as it is for a sole proprietorship, especially in the early stages of an LLC's business operations. Most lenders require LLC members to personally guarantee any loans the LLC may

take out.

Finally, LLCs are not the right form for taking a company public and selling stock. Fortunately, it is not difficult to convert an LLC into a corporation, so many start-up businesses begin as LLCs and eventually convert into corporations prior to their initial public offering (IPO).

## 4. Limited Liability Partnerships

A related entity to the LLC is the **limited liability partnership (LLP)**. Be careful not to confuse limited liability partnerships with limited partnerships.

LLPs are just like LLCs, but are designed for professionals who do business as partners. They allow the partnership to pass through income for tax purposes, but retain limited liability for all partners. LLPs are especially popular with doctors, architects, accountants, and lawyers. Most of the major accounting firms have now converted their corporate forms into LLPs.

Compared to limited partnerships, LLC members can participate in day-to-day management of the business. Compared to S corporations, LLC members can be other corporations or partnerships, are not restricted in number, and may be residents of other countries.



### TERM TO KNOW

#### Limited Liability Partnership (LLP)

A form of business organization that allows the partnership to pass through income for tax purposes, but retain limited liability for all partners.



### SUMMARY

In this lesson, you learned that the **purpose of limited liability companies (LLCs)** is to give owners, called members, limited liability just like corporations. Unlike corporations, however, LLCs can avoid double taxation by choosing to be taxed like a partnership or sole proprietorship. The **formation of an LLC** is also simpler than that of a corporation, as LLCs have fewer legal requirements to meet when starting up. Some **disadvantages of LLCs**, however, are that fundraising can be difficult and company stock cannot be publicly traded. The **limited liability partnership (LLP)** is similar to the LLC, except it is designed for professionals, such as accountants or lawyers, who do business as partners.

Best of luck in your learning!

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## TERMS TO KNOW

### **Articles of Organization**

The state filing required to start an LLC. For corporations, these are called articles of incorporation.

### **Limited Liability Company (LLC)**

A hybrid between a corporation and a partnership in that it is a separate entity but has fewer formalities than a corporation. It is a simpler form of entity than a corporation but also has limited liability of its owners like a corporation, and unlike a partnership. It can only be formed under state law.

### **Limited Liability Partnership (LLP)**

A form of business organization that allows the partnership to pass through income for tax purposes, but retain limited liability for all partners.

### **Operating Agreement**

The contract between members of an LLC.

# The Courts and the Legal Process

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the different court systems in the U.S., and how they interact with one another. Specifically, this lesson will cover:

1. Purpose of Courts in the Legal System
2. Obligations of State Courts to Federal Law
3. Federal Cases Involving State Law
  - 3a. Diversity Jurisdiction Cases

## 1. Purpose of Courts in the Legal System

In the United States, law and government are interdependent. The Constitution establishes the basic framework of government and imposes certain limitations on the powers of government.

In turn, the various branches of government are intimately involved in making, enforcing, and interpreting the law. Today, much of the law comes from Congress and the state legislatures. But it is in the courts that legislation is interpreted, and prior case law is interpreted and applied.



### THINK ABOUT IT

As you go through this lesson and those that follow, consider the case of Harry and Kay Robinson:

1. *In which court should the Robinsons file their action?*
2. *Can the Oklahoma court hear the case and make a judgment that will be enforceable against all of the defendants?*
3. *Which law will the court use to come to a decision?*
4. *Will it use New York law, Oklahoma law, federal law, or German law?*

### CASE STUDY: *World-Wide Volkswagen Corp. v. Woodson*

Harry and Kay Robinson purchased a new Audi automobile from Seaway Volkswagen, Inc. (Seaway) in Massena, New York in 1976. The following year, the Robinson family, who resided in New York, left that state for a new home in Arizona. As they passed through Oklahoma, another car struck their Audi in



the rear, causing a fire that severely burned Kay Robinson and her two children.

Later on, the Robinsons brought a products-liability action in the District Court for Creek County, Oklahoma, claiming that their injuries resulted from the defective design and placement of the Audi's gas tank and fuel system. They sued numerous defendants, including the automobile's manufacturer, Audi NSU Auto Union Aktiengesellschaft (Audi); its importer, Volkswagen of America, Inc. (Volkswagen); its regional distributor, World-Wide Volkswagen Corp. (World-Wide); and its retail dealer, Seaway.

## 2. Obligations of State Courts to Federal Law

Although it is sometimes said that there are two separate court systems, the reality is more complex. There are, in fact, fifty-two court systems:

- Those of the fifty states
- The local court system in the District of Columbia
- The federal court system

At the same time, these are not entirely separate; they all have several points of contact. State and local courts must honor both federal law and the laws of the other states.

First, state courts must honor federal law where state laws are in conflict with federal laws (under the supremacy clause of the Constitution).

Second, claims arising under federal statutes can often be tried in the state courts, where the Constitution or Congress has not explicitly required that only federal courts can hear those kinds of claims.

Third, under the full faith and credit clause of the Constitution, each state court is obligated to respect the final judgments of courts in other states.

⇒ **EXAMPLE** A contract dispute resolved by an Arkansas court cannot be re-litigated in North Dakota when the plaintiff wants to collect on the Arkansas judgment in North Dakota.

Fourth, state courts often must consider the laws of other states in deciding cases involving issues where two states have an interest, such as when drivers from two different states collide in a third state. Under these circumstances, state judges will consult their own state's case decisions involving **conflict of laws** and sometimes decide that they must apply another state's laws to decide the case.



### TERM TO KNOW

#### Conflict of Laws

An area of legal study of each state that determines which law applies when a case relates to the law of more than one state.

# 3. Federal Cases Involving State Law

As state courts are concerned with federal law, so federal courts are often concerned with state law and with what happens in state courts. Federal courts will consider state-law-based claims when a case involves claims using both state and federal laws. Claims based on federal laws will permit the federal court to take jurisdiction over the whole case, including any state issues raised.

In those cases, the federal court is said to exercise **pendent jurisdiction** over the state claims. Also, the U.S. Supreme Court will occasionally take appeals from a state Supreme Court where state law raises an important issue of federal law to be decided.

⇒ **EXAMPLE** A convict on death row may claim that the state's chosen method of execution using the injection of drugs is unusually painful and involves **cruel and unusual punishment**, violating the Eighth Amendment of the Constitution.



## TERMS TO KNOW

### Pendent Jurisdiction

The type of discretionary jurisdiction a federal court takes over a related matter when it has original jurisdiction over a federal law claim where both claims arise from the same facts.

### Cruel and Unusual Punishment

Punishment prohibited by the Eighth Amendment of the U.S. Constitution; punishment considered by societal norms as barbaric or torturous; punishment not known to the common law; punishment so disproportionate to the offense that it shocks the moral sense of society.

## 3a. Diversity Jurisdiction Cases

There is also a broad category of cases heard in federal courts that concern only state legal issues— namely, cases that arise between citizens of different states. The federal courts are permitted to hear these cases under their diversity of citizenship jurisdiction, or simply **diversity jurisdiction**.

⇒ **EXAMPLE** A citizen of New Jersey may sue a citizen of New York over a contract dispute in federal court, but if both were citizens of New Jersey, the plaintiff would be limited to the state courts.

The Constitution established diversity jurisdiction because it was feared that local courts would be hostile toward people from other states and that they would need separate courts. In 2018, nearly a third of all civil suits filed in federal court were based on diversity of citizenship. In these cases, the federal courts were applying state law, rather than taking federal question jurisdiction, where federal law provided the basis for the lawsuit or where the United States was a party (as plaintiff or defendant).

In addition to diversity of citizenship between parties, diversity jurisdiction has a monetary threshold of \$75,000. If the **amount in controversy** is less than \$75,000, then the case cannot be heard in federal court based on diversity alone.

Why are there so many diversity cases in federal courts? Defense lawyers believe that there is sometimes a “home-court advantage” for an in-state plaintiff who brings a lawsuit against a nonresident in his local state court. The defense attorney is entitled to ask for **removal** to a federal court where there is diversity. This fits with the original reason for diversity jurisdiction in the Constitution— the concern that judges in one state court would favor the in-state plaintiff rather than a nonresident defendant.

Another reason there are so many diversity cases is that plaintiffs’ attorneys know that removal is common and that it will move the case along faster by filing in federal court to begin with. Some plaintiffs’ attorneys also find advantages in pursuing a lawsuit in federal court.

Federal court procedures are often more efficient than state court procedures, so that federal dockets are often less crowded. This means a case will get to trial faster, and many lawyers enjoy the higher status that comes in practicing before the federal bench. In some federal districts, judgments for plaintiffs may be higher, on average, than in the local state court.

In short, not only law but also legal strategy factor into the popularity of diversity cases in federal courts.



#### TERMS TO KNOW

##### Diversity Jurisdiction

A type of subject matter jurisdiction exercised by a federal district court under Article III, Section 2 of the U.S. Constitution allowing the court to take civil cases between citizens of different states. The amount in controversy must also exceed a certain amount, currently \$75,000.

##### Amount in Controversy

The amount of money involved in a civil claim brought in a federal district court to determine if diversity jurisdiction can be asserted.

##### Removal

The procedure in federal district court whereby a civil action brought in state court may be transferred to federal court so long as the federal court has subject matter jurisdiction.



#### SUMMARY

In this lesson, you learned that **state and federal courts serve different purposes in the legal system**. Still, these courts often have cause to interact with one another. **State courts have an obligation to honor federal law**, meaning that these courts sometimes hear cases pertaining to federal law issues. Likewise, **federal cases sometimes involve state law issues**, such as **diversity jurisdiction**. Within both state and federal court systems, it is useful to know the different kinds of courts and the types of cases they can decide.

Best of luck in your learning!

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## TERMS TO KNOW

### **Amount in Controversy**

The amount of money involved in a civil claim brought in a federal district court to determine if diversity jurisdiction can be asserted.

### **Conflict of Laws**

An area of legal study of each state that determines which law applies when a case relates to the law of more than one state.

### **Cruel and Unusual Punishment**

Punishment prohibited by the Eighth Amendment of the U.S. Constitution; punishment considered by societal norms as barbaric or torturous; punishment not known to the common law; punishment so disproportionate to the offense that it shocks the moral sense of society.

### **Diversity Jurisdiction**

A type of subject matter jurisdiction exercised by a federal district court under Article III, Section 2 of the U.S. Constitution allowing the court to take civil cases between citizens of different states. The amount in controversy must also exceed a certain amount, currently \$75,000.

### **Pendent Jurisdiction**

The type of discretionary jurisdiction a federal court takes over a related matter when it has original jurisdiction over a federal law claim where both claims arise from the same facts.

### **Removal**

The procedure in federal district court whereby a civil action brought in state court may be transferred to federal court so long as the federal court has subject matter jurisdiction.

# State Courts in the U.S.

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the role of state courts in the U.S. legal system. Specifically, this lesson will cover:

### 1. The State Court Systems

#### 1a. Limited Jurisdiction Courts

#### 1b. General Jurisdiction Courts

#### 1c. Appellate Courts

## 1. The State Court Systems

The vast majority of civil lawsuits in the United States are filed in state courts. Two aspects of civil lawsuits are common to all state courts:

- Trials
- Appeals

A court exercising a trial function has original jurisdiction— that is, jurisdiction to determine the facts of the case and apply the law to them.

A court that hears appeals from the trial court is said to have appellate jurisdiction, meaning it must accept the facts as determined by the trial court and limit its review to the lower court's theory of the applicable law. Jury trials only occur in trial courts.

In most large urban states and many smaller states, there are four or five levels of courts.

### 1a. Limited Jurisdiction Courts

The lowest level is that of the **limited jurisdiction courts**. These are usually county or municipal courts with original jurisdiction to hear minor criminal cases (petty assaults, traffic offenses, and breach of peace, among others) and civil cases involving monetary amounts up to a fixed ceiling (typically \$3,000-\$12,000, varying by state).

Most disputes that wind up in court are handled in the 18,000-plus limited jurisdiction courts, which are estimated to hear more than 80 percent of all cases.



## TERM TO KNOW

### Limited Jurisdiction Courts

Courts with limited subject matter jurisdiction such as bankruptcy, family, small claims courts, traffic court, probate courts, etc. Unlike general jurisdiction courts, these courts derive their limited authority from a specific provision in a statute or constitution.

## 1b. General Jurisdiction Courts

All other civil and criminal cases are heard in the general trial courts, or courts of general jurisdiction. These go by a variety of names:

- Superior Court
- Circuit Court
- District Court
- Common Pleas Court



## DID YOU KNOW

New York calls its general trial court the Supreme Court.

These are the courts in which people seek redress for incidents such as automobile accidents and injuries or breach of contract. These state courts also prosecute those accused of murder, rape, robbery, and other serious crimes.

The fact-finder in these **general jurisdiction courts** can be a judge or jury unless a jury trial is not available, as is most often the case in family law matters. Even where a jury trial is allowed, parties may waive their right to a jury trial and have a judge decide their case if they elect to do so.

Although courts of general jurisdiction can hear all types of cases, in most states more than half involve family matters (divorce, child custody disputes, and the like). A third are commercial cases, and slightly over 10 percent are devoted to car accident cases and other torts.)

Most states have specialized courts that hear only a certain type of case, such as landlord-tenant disputes or probate of wills.



## TERM TO KNOW

### General Jurisdiction Courts

Courts that can hear cases about any dispute or controversy unless such disputes can only be heard in a court of special jurisdiction, such as a bankruptcy or case.

## 1c. Appellate Courts

The losing party in a general jurisdiction court can almost always appeal to either one or two higher courts. These **intermediate appellate courts** - usually called courts of appeal - have been established in forty-one states.

They do not retry the evidence, but rather determine whether the trial was conducted in a procedurally correct manner and whether the appropriate law was applied.

### IN CONTEXT

The **appellant** (the losing party who appeals) might complain that the judge wrongly instructed the jury on the meaning of the law, or improperly allowed testimony of a particular witness, or misconstrued the law in question. The **appellee** (who won in the lower court) will ask that the appellant be denied. Usually, this means that the appellee wants the lower-court judgment affirmed. The appellate court has quite a few choices: it can **affirm**, **modify**, **reverse**, or **reverse and remand** (return the case to the lower court for retrial).

The last type of appeal within the state courts system is to the highest court - the State Supreme Court - which is composed of a single panel of between five and nine judges and is usually located in the state capital. The intermediate appellate courts are usually composed of panels of three judges and are situated in various locations around the state.

In a few states, the highest court goes by a different name.

⇒ **EXAMPLE** In New York, it is known as the Court of Appeals.

In certain cases, appellants to the highest court in a state have the right to have their appeals heard, but more often the Supreme Court selects the cases it wishes to hear. For most litigants, the ruling of the State Supreme Court is final.

In a relatively small class of cases - those in which federal constitutional claims are made - appeal to the U.S. Supreme Court to issue a **writ of certiorari** remains a possibility. The Supreme Court does not accept all cases by writ of certiorari, but does accept selected cases.



### TERMS TO KNOW

#### Intermediate Appellate Courts

Courts of appeal that are not the final appeals court in a particular jurisdiction. In the federal system, these are called circuit courts of appeal (the Supreme Court being the final appeal).

#### Appellant

The party who appeals a court's decision.

#### Appellee

The party who has not appealed a court's decision but must respond to the appellant's appeal. Also referred to as a respondent.

#### Affirm

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court affirms the lower court's decision, the appellant has lost the appeal.

#### Modify

One of several potential outcomes of an appeal of a court decision to a higher court. The appeals court has the ability to modify, or change, the decision of the lower court, while keeping parts of the decision.

### Reverse

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court disagrees with the lower court's decision, it will reverse it, or will reverse it in part, making void the part of the decision the appeals court found to be incorrect.

### Reverse and Remand

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court reverses the lower court decision, it will often remand the case to the lower court, with instructions on how to decide the case. Remand may also require the trial court to take in more evidence.

### Writ of Certiorari

An order by an appellate court (typically a Supreme Court) used when the court has discretion whether or not to take an appeal. If the writ is denied, the judgment below stands. If the writ is granted, the appeal will go forward.



## SUMMARY

In this lesson, you learned that **the state court systems** handle trials and appeals for civil lawsuits. The lowest level of state courts are **limited jurisdiction courts**, which handle minor criminal cases and civil cases involving lower monetary amounts. Next are **general jurisdiction courts**, which typically handle family, commercial, or accident cases. Finally, **appellate courts** are the highest level. These courts determine whether the initial trial was fair in terms of how it was conducted and if the relevant law was applied.

Best of luck in your learning!

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## TERMS TO KNOW

### Affirm

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court affirms the lower court's decision, the appellant has lost the appeal.

### Appellant



The party who appeals a court's decision.

**Appellee**

The party who has not appealed a court's decision but must respond to the appellant's appeal. Also referred to as a respondent.

**General Jurisdiction Courts**

Courts that can hear cases about any dispute or controversy unless such disputes can only be heard in a court of special jurisdiction, such as a bankruptcy or case.

**Intermediate Appellate Courts**

Courts of appeal that are not the final appeals court in a particular jurisdiction. In the federal system, these are called circuit courts of appeal (the Supreme Court being the final appeal).

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Courts with limited subject matter jurisdiction such as bankruptcy, family, small claims courts, traffic court, probate courts, etc. Unlike general jurisdiction courts, these courts derive their limited authority from a specific provision in a statute or constitution.

**Modify**

One of several potential outcomes of an appeal of a court decision to a higher court. The appeals court has the ability to modify, or change, the decision of the lower court, while keeping parts of the decision.

**Reverse**

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court disagrees with the lower court's decision, it will reverse it, or will reverse it in part, making void the part of the decision the appeals court found to be incorrect.

**Reverse and Remand**

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court reverses the lower court decision, it will often remand the case to the lower court, with instructions on how to decide the case. Remand may also require the trial court to take in more evidence.

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An order by an appellate court (typically a Supreme Court) used when the court has discretion whether or not to take an appeal. If the writ is denied, the judgment below stands. If the writ is granted, the appeal will go forward.

# Federal Courts in the U.S.

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the role of federal courts in the U.S. legal system. Specifically, this lesson will cover:

### 1. The Federal Court System

#### 1a. District Courts

#### 1b. Courts of Appeal

#### 1c. United States Supreme Court

## 1. The Federal Court System

The federal judicial system is uniform throughout the United States and consists of three levels:

- District Courts
- Courts of Appeal
- United States Supreme Court

### 1a. District Courts

At the first level are the federal district courts, which are the 94 trial courts in the federal system. Every state has one or more federal districts; the less populous states have one, and the more populous states - California, Texas, and New York - have four.

The federal court with the heaviest commercial docket is the U.S. District Court for the Southern District of New York (Manhattan). The district judges throughout the United States commonly preside over all federal trials, both criminal and civil.

Federal judges - including Supreme Court justices - are nominated by the President and must be confirmed by the Senate. Unlike state judges, who are usually elected and preside for a fixed term of years, federal judges are appointed and sit for life unless they voluntarily retire or are impeached.

To assist the district courts, there are also 531 **U.S. magistrate judges** who serve under the district judge. These magistrates serve for set periods of time (not for life as judges and justices do), and they hear cases, issue search and arrest warrants, preside over misdemeanors or petty criminal trials, set bail, etc.



## TERM TO KNOW

### U.S. Magistrate Judges

Federal judges serving in the U.S. District Court under a district court judge. District court judges are appointed for life, while magistrate judges are appointed for limited terms and can only hear cases assigned to them by the district court judges.

## 1b. Courts of Appeal

Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are 13. Each circuit oversees the work of the district courts in several states.

### IN CONTEXT

The U.S. Court of Appeals for the Second Circuit hears appeals from district courts in New York, Connecticut, and Vermont.

The U.S. Court of Appeals for the Ninth Circuit hears appeals from district courts in California, Oregon, Nevada, Montana, Washington, Idaho, Arizona, Alaska, Hawaii, and Guam.

The U.S. Court of Appeals for the District of Columbia Circuit hears appeals from the district court in Washington, DC, as well as from numerous federal administrative agencies.

The U.S. Court of Appeals for the Federal Circuit, also located in Washington, DC., hears appeals in patent and customs cases.

Appeals are usually heard by three-judge panels, but sometimes there will be a rehearing at the court of appeals level, in which case all judges sit to hear the case **en banc**.

There are also several specialized courts in the federal judicial system. These include:

- U.S. Tax Court
- Court of Customs and Patent Appeals
- U.S. Bankruptcy Court
- Court of Claims



## TERM TO KNOW

### En Banc

A term referring to the entire panel of judges comprising a court. Typically, matters are heard by one judge or a panel of judges. A court will hear a matter en banc at its discretion, usually when a case is considered of particular importance.

## 1c. United States Supreme Court

Overseeing all federal courts is the U.S. Supreme Court in Washington, DC. It consists of nine justices— the chief justice and eight associate justices.



#### DID YOU KNOW

This number is not constitutionally required; Congress can establish any number. It has been set at nine since after the Civil War.

The Supreme Court has selective control over most of its docket. By law, the cases it hears represent only a tiny fraction of the cases that are submitted. The Supreme Court has over 7,000 petitions (typically called petitions for a writ of certiorari) per year, not including thousands of petitions from prisoners; however, it hears arguments in only 100-150 cases.

The Supreme Court does not sit in panels. All the justices hear and consider each case together, unless a justice has a conflict of interest and must withdraw from hearing the case.



#### SUMMARY

In this lesson, you learned that **the federal court system** is comprised of three levels. At the first level are **district courts**, which are responsible for both civil and criminal trials at the federal level. There are 94 district courts, and each state has at least one. At the next level are **courts of appeal**, which oversee appeals for district court cases. Finally, at the highest level is the **United States Supreme Court**, which oversees all federal courts, but ultimately only takes a small portion of the cases submitted to it.

Best of luck in your learning!

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#### TERMS TO KNOW

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##### U.S. Magistrate Judges

Federal judges serving in the U.S. District Court under a district court judge. District court judges are appointed for life, while magistrate judges are appointed for limited terms and can only hear cases assigned to them by the district court judges.

# Subject Matter Jurisdiction

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the concept of subject matter jurisdiction, and how it impacts legal proceedings in the United States.

1. What Is Subject Matter Jurisdiction?
2. The Federal-State Balance
3. Exclusive Jurisdiction in Federal Courts
4. Concurrent Jurisdiction
5. General Rules of Subject Matter Jurisdiction

## 1. What Is Subject Matter Jurisdiction?

Jurisdiction is an essential concept in understanding courts and the legal system. Jurisdiction is a combination of two Latin words: *juris* (law) and *diction* (to speak). Which court has the power “to speak the law” is the basic question of jurisdiction.

There are two questions about jurisdiction that must be answered before a judge will hear a case:

- The question of **subject matter jurisdiction**
- The question of **personal jurisdiction**

Here, we will consider the question of subject matter jurisdiction first, because judges do; if they determine, on the basis of the initial documents in the case (the “pleadings”), that they have no power to hear and decide that kind of case, they will dismiss it.

To put this in perspective, the Constitution was constructed with the idea that state courts would continue to deal with basic kinds of claims, such as tort, contract, or property claims.



### DID YOU KNOW

State courts have their origins in colonial era courts. After the American Revolution, state courts functioned (with some differences) much like they did in colonial times. The big difference after 1789 was that state courts coexisted with federal courts.

Since states sanction marriages and divorce, state courts would deal with “domestic” (family) issues. Likewise, since states deal with birth and death records, it stands to reason that paternity suits, probate disputes, and the

like usually wind up in state courts.

⇒ **EXAMPLE** You cannot get married or divorced in federal court, because federal courts have no jurisdiction over matters that are historically (and are still) exclusively within the domain of state law. Matters that historically get raised and settled in state court under state law include not only domestic and probate matters, but also law relating to corporations, partnerships, agency, contracts, property, torts, and commercial dealings generally.

In terms of subject matter jurisdiction, then, state courts will typically deal with the kinds of disputes just cited.

⇒ **EXAMPLE** If you are a Michigan resident and have an auto accident in Toledo with an Ohio resident and you blame each other for the accident, the state courts would ordinarily resolve the matter if the dispute cannot otherwise be settled.

People have had a need to resolve this kind of dispute long before our federal courts were created, and you can tell from Article III that the founders did not specify that tort or negligence claims should be handled by the federal courts.

Again, federal courts are courts of **limited jurisdiction**, limited to the kinds of cases specified in Article III. If the case before the federal court does not fall within one of those categories, the federal court cannot constitutionally hear the case because it does not have subject matter jurisdiction.



#### BIG IDEA

A court must have subject matter jurisdiction to hear and decide a case. Without it, a court cannot address the merits of the controversy or even take the next jurisdictional step of figuring out which of the defendants can be sued in that court. The question of which defendants are appropriately before the court is a question of personal jurisdiction. An easy way to remember this is that you would not be able to file for bankruptcy in a court that handles family law. Only U.S. Bankruptcy Court can hear bankruptcy cases due to subject matter jurisdiction.



#### TERMS TO KNOW

##### **Subject Matter Jurisdiction**

A court's power to hear and determine cases of a certain class or category of cases.

##### **Personal Jurisdiction**

The authority a court has over a person being sued. The U.S. Constitution requires that in order for a court to have power over a person, that person must have minimum contacts with the forum (geographical area covered by the court). A court lacking personal jurisdiction over someone cannot issue a judgment against that person.

##### **Limited Jurisdiction**

Limitations on the subject matter courts can hear and determine.

---

## 2. The Federal-State Balance

Federalism was the system devised by the nation's founders in which power is shared between states and the federal government. This sharing requires a division of labor between the states and the federal government.

It is Article III of the U.S. Constitution that spells out the respective spheres of authority (jurisdiction) between state and federal courts.

### IN CONTEXT

Take a close look at [Article III of the Constitution](#). Article III makes clear that federal courts are courts of limited power or jurisdiction. Notice that the only kinds of cases federal courts are authorized to deal with aside from diversity jurisdiction have strong federal connections.

For example, federal courts have jurisdiction when a federal law is being used by the plaintiff or prosecutor (a **federal question** case) or the case arises in **admiralty** (meaning that the problem arose not on land but on sea, beyond the territorial jurisdiction of any state, or in navigable waters within the United States) or is about **intellectual property**, as in trademarks, copyright, or patents.

Implied in this list is the clear notion that states would continue to have their own laws, interpreted by their own courts, and that federal courts were needed only where the issues raised by the parties had a clear federal connection. The exception to this, of course, is diversity jurisdiction, as we discussed previously.

Because there are two court systems, it is important for a plaintiff to file in the right court to begin with. The right court is the one that has subject matter jurisdiction over the case— that is, the power to hear and decide the kind of case that is filed. Not only is it a waste of time to file in the wrong court system and be dismissed, but if the dismissal comes after the filing period imposed by the applicable **statute of limitations**, it will be too late to refile in the correct court system.

Such cases will be routinely dismissed, regardless of how deserving the plaintiff might be in his quest for justice. The plaintiff's only remedy at that point would be to sue his lawyer for negligence for failing to mind the clock and get to the right court in time!



### TERMS TO KNOW

#### Federal Question

A type of subject matter jurisdiction giving federal courts the power to hear questions of federal law.

#### Admiralty

The area of law that deals with ships, the sea, or other navigable waters.

#### Intellectual Property

A type of personal property derived from a person's creativity, such as a patent, trademark, copyright, etc.

#### Statute of Limitations

### 3. Exclusive Jurisdiction in Federal Courts

As noted earlier, federal courts have exclusive jurisdiction over certain kinds of cases. By excluding diversity cases, we can assemble a list of the kinds of cases that can only be heard in federal courts:

1. Suits between states: Cases in which two or more states are a party
2. Cases involving ambassadors and other high-ranking public figures: Cases in which ambassadors or other high-ranking public officials are parties
3. Federal crimes: Crimes defined by or mentioned in the U.S. Constitution or those defined or punished by federal statute; such crimes include treason against the United States, piracy, counterfeiting, crimes against the law of nations, and crimes relating to the federal government's authority to regulate interstate commerce. However, most crimes are state matters.
4. Bankruptcy: The statutory procedure, usually triggered by **insolvency**, by which a person is relieved of most debts and undergoes a judicially supervised reorganization or liquidation for the benefit of the person's creditors
5. Patent, copyright, and trademark cases
  - a. *Patent*: The exclusive right to make, use, or sell an invention for a specified period (usually seventeen years), granted by the federal government to the inventor if the device or process is novel, useful, and non-obvious
  - b. *Copyright*: The body of law relating to a property right in an original work of authorship (such as a literary, musical, artistic, photographic, or film work) fixed in any tangible medium of expression, giving the holder the exclusive right to reproduce, adapt, distribute, perform, and display the work
  - c. *Trademark*: A word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others
6. Admiralty: The system of laws that has grown out of the practice of admiralty courts, or courts that exercise jurisdiction over all maritime contracts, torts, injuries, and offenses
7. Antitrust: Federal laws designed to protect trade and commerce from restraining monopolies, price fixing, and price discrimination
8. Securities and banking regulation: The body of law protecting the public by regulating the registration, offering, and trading of securities and the regulation of banking practices
9. Other cases specified by federal statute: Any other cases specified by a federal statute where Congress declares that federal courts will have exclusive jurisdiction



#### TERM TO KNOW

##### **Insolvency**

The financial inability by a debtor (individual or business) to pay debts as they come due.



## 4. Concurrent Jurisdiction

When a plaintiff takes a case to state court, it will be because state courts typically hear that kind of case (i.e., there is subject matter jurisdiction).

If the plaintiff's main cause of action comes from a certain state's constitution, statutes, or court decisions, the state courts have subject matter jurisdiction over the case. If the plaintiff's main cause of action is based on federal law (e.g., Title VII of the Civil Rights Act of 1964), the federal courts have subject matter jurisdiction over the case.

But federal courts will also have subject matter jurisdiction over certain cases that have only a state-based cause of action; those cases are ones in which the plaintiff(s) and the defendant(s) are from different states and the amount in controversy is more than \$75,000.

State courts can have subject matter jurisdiction over certain cases that have only a federal-based cause of action. Therefore, state courts have **concurrent jurisdiction** of any federal cause of action unless Congress has given exclusive jurisdiction to federal courts.

In short, a case with a federal question can often be heard in either state or federal court, and a case that has parties with a diversity of citizenship can be heard in state courts or in federal courts where the tests of complete diversity and amount in controversy are met.

Whether a case will be heard in a state court or moved to a federal court will depend on the parties. If a plaintiff files a case in state trial court where concurrent jurisdiction applies, a defendant may (or may not) ask that the case be removed to federal district court.



### TERM TO KNOW

#### Concurrent Jurisdiction

The jurisdiction of more than one court, each authorized to decide the same subject matter at the choice of the plaintiff.

---

## 5. General Rules of Subject Matter Jurisdiction

When considering the basic rules of subject matter jurisdiction, refer to the following list:

1. A court must always have subject matter jurisdiction, and personal jurisdiction over at least one defendant, to hear and decide a case.
2. A state court will have subject matter jurisdiction over any case that is not required to be brought in a federal court. Some cases can *only* be brought in federal court, such as bankruptcy cases, cases involving federal crimes, patent cases, and Internal Revenue Service tax court claims. The list of cases for exclusive federal jurisdiction is fairly short. That means that almost any state court will have subject matter jurisdiction

over almost any kind of case. If it's a case based on state law, a state court will always have subject matter jurisdiction.

3. A federal court will have subject matter jurisdiction over any case that is either based on a federal law (statute, case, or U.S. Constitution) OR a federal court will have subject matter jurisdiction over any case based on state law in two specific instances:
  - a. *The parties are from different states*: This requirement means that no plaintiff can have permanent residence in a state where any defendant has permanent residence— there must be complete diversity of citizenship between all plaintiffs and defendants.
  - b. *The amount in controversy is at least \$75,000*: This requirement means that a good-faith estimate of the amount the plaintiff may recover is at least \$75,000.
4. In diversity cases:
  - a. Federal civil procedure rules apply to how the case is conducted before and during trial and any appeals.
  - b. State law will be used as the basis for a determination of legal rights and responsibilities. This **choice of law** process is interesting but complicated. Basically, each state has its own set of judicial decisions that resolve conflict of laws.

#### **CASE STUDY: *World-Wide Volkswagen Corp. v. Woodson***

Recall the case mentioned in a previous lesson: Mr. and Mrs. Robinson and their products-liability claim against Seaway Volkswagen and the other three defendants. There is no federal products-liability law that could be used as a cause of action. They are most likely suing the defendants using products-liability law based on common-law negligence or common-law strict liability law, as found in state court cases. They were not yet Arizona residents at the time of the accident, and their accident does not establish them as Oklahoma residents, either. They bought the vehicle in New York from a New York-based retailer. None of the other defendants is from Oklahoma.

They file in an Oklahoma state court, but how will they (their attorney or the court) know if the state court has subject matter jurisdiction? Unless the case is *required* to be in a federal court (i.e., unless the federal courts have exclusive jurisdiction over this kind of case), any state court system will have subject matter jurisdiction, including Oklahoma's state court system. But if their claim is for a significant amount of money, they cannot file in small claims court, probate court, or any court in Oklahoma that does not have statutory jurisdiction over their claim. They will need to file in a court of general jurisdiction. In short, even when filing in the right court system (state versus federal), the plaintiff must be careful to find the court that has subject matter jurisdiction.

If they wish to go to federal court, can they? There is no federal question presented here (the claim is based on state common law), and the United States is not a party, so the only basis for federal court jurisdiction would be diversity jurisdiction. If enough time has elapsed since the accident and they have established themselves as Arizona residents, they could sue in federal court in Oklahoma (or elsewhere), but only if none of the defendants— the retailer, the regional Volkswagen company,

Volkswagen of North America, or Audi (in Germany) are incorporated in or have a principal place of business in Arizona. The federal judge would decide the case using federal civil procedure but would have to make the appropriate choice of state law. In this case, the choice of conflicting laws would most likely be Oklahoma, where the accident happened, or New York, where the defective product was sold.



#### TERM TO KNOW

##### Choice of Law

In conflict of laws (as when laws of different states may apply), the choice by a court of which law should govern a case.



#### SUMMARY

In this lesson, you learned that **subject matter jurisdiction** is the determination of whether a state court or federal court has the authority to oversee a particular type of case. The purpose of subject matter jurisdiction is to maintain **the federal-state balance** in which there is a division of responsibilities between states and the federal government. However, some cases have **exclusive jurisdiction in federal courts**, while others can have **concurrent jurisdiction**. There are some **general rules for subject matter jurisdiction** that can help in determining which court has the power to hear a particular case.

Best of luck in your learning!

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#### TERMS TO KNOW

##### Admiralty

The area of law that deals with ships, the sea, or other navigable waters.

##### Choice of Law

In conflict of laws (as when laws of different states may apply), the choice by a court of which law should govern a case.

##### Concurrent Jurisdiction

The jurisdiction of more than one court, each authorized to decide the same subject matter at the choice of the plaintiff.

**Federal Question**

A type of subject matter jurisdiction giving federal courts the power to hear questions of federal law.

**Insolvency**

The financial inability by a debtor (individual or business) to pay debts as they come due.

**Intellectual Property**

A type of personal property derived from a person's creativity, such as a patent, trademark, copyright, etc.

**Limited Jurisdiction**

Limitations on the subject matter courts can hear and determine.

**Personal Jurisdiction**

The authority a court has over a person being sued. The U.S. Constitution requires that in order for a court to have power over a person, that person must have minimum contacts with the forum (geographical area covered by the court). A court lacking personal jurisdiction over someone cannot issue a judgment against that person.

**Statute of Limitations**

A statute that limits the time within which an action can be filed in court.

**Subject Matter Jurisdiction**

A court's power to hear and determine cases of a certain class or category of cases.

# Personal Jurisdiction

by Sophia



## WHAT'S COVERED

In this lesson, you will learn how lawsuits are begun and how the court knows that it has both subject matter jurisdiction and personal jurisdiction over at least one of the named defendants. Specifically, this lesson will cover:

1. The Adversary System
2. Method of Adjudication
  - 2a. Burden of Proof
3. Beginning a Lawsuit
  - 3a. Complaint and Summons
  - 3b. Jurisdiction and Venue
4. Service of Process and Personal Jurisdiction
5. General Rules of Personal Jurisdiction
6. Choice of Law and Choice of Forum Clauses

## 1. The Adversary System

The courts are not the only institutions that can resolve disputes. Later, we will discuss other dispute-resolution forums, such as arbitration and mediation. For now, let us consider how courts make decisions in civil disputes. Judicial decision-making in the context of litigation (civil lawsuits) is a distinctive form of dispute resolution.

First, to get the attention of a court, the plaintiff must make a claim based on existing laws. Second, courts do not reach out for cases. Cases are brought to them, usually when an attorney files a case with the right court in the right way, following the various laws that govern all civil procedures in a state or in the federal system. Most US states' procedural laws are similar to the federal procedural code.

Once at the court, the case will proceed through various motions (motions to dismiss for lack of jurisdiction, for example, or insufficient service of process), the proofs (submission of evidence), and the arguments (debate about the meaning of the evidence and the law) of contesting parties.

This is at the heart of the **adversary system**, in which those who oppose each other may attack the other's case through proofs and cross-examination. Every person in the United States who wishes to take a case to court is

entitled to hire a lawyer. The lawyer works for his client, not the court, and serves him as an advocate, or supporter. The client's goal is to persuade the court of the accuracy and justness of his position.

The lawyer's duty is to shape the evidence and the argument - the line of reasoning about the evidence - to advance his client's cause and persuade the court of its rightness. The lawyer for the opposing party will be doing the same thing, of course, for her client. The judge (or, if one is sitting, the jury) must sort out the facts and reach a decision from this cross-fire of evidence and argument.



#### TERM TO KNOW

##### Adversary System

The legal system in use in the U.S. whereby courts hear evidence from parties in a case who advocate for themselves, while the judge acts as an independent arbiter of the facts and law. Distinguished from the inquisitorial system where the judge investigates.

## 2. Method of Adjudication

The method of adjudication - the act of making an order or judgment - has several important features. First, it focuses the conflicting issues. Other, secondary concerns are minimized or excluded altogether. Relevance is a key concept in any trial. The judge is required to decide the questions presented at the trial, not to talk about related matters.

Second, adjudication requires that the judge's decision be reasoned, and that is why judges write opinions explaining their decisions (an opinion may be omitted when the verdict comes from a jury).

Third, the judge's decision must not only be reasoned, but also be responsive to the case presented: The judge is not free to say that the case is unimportant and that she, therefore, will ignore it.

Unlike other branches of government that are free to ignore problems pressing upon them, judges must decide cases.

⇒ **EXAMPLE** A legislature need not enact a law, no matter how many people petition it to do so.

Fourth, the court must respond in a certain way. The judge must pay attention to the parties' arguments and the decision must result from their proofs and arguments. Evidence that is not presented and legal arguments that are not made cannot be the basis for what the judge decides, although a judge may take what is called **judicial notice** of obvious facts or conditions. Also, judges are bound by standards of weighing evidence: The burden of proof in a civil case is generally a **preponderance of the evidence**.



#### TERMS TO KNOW

##### Judicial Notice

The custom allowing a judge to take notice of events that are commonly known, such as the weather or a well-known event, without having to take in evidence of same.

##### Preponderance of the Evidence

A standard of proof whereby a fact is proven in civil cases; such evidence is of greater weight or more convincing than the evidence offered in opposition to it. Distinguished from "beyond a reasonable doubt," the standard in criminal cases.

## 2a. Burden of Proof

In all cases, the plaintiff - the party making a claim and initiating the lawsuit (in a criminal case the plaintiff is the prosecution) - has the burden of proving the case. If the proof fails, the defendant - the party being sued or prosecuted - will win.

Criminal prosecutions carry the most rigorous burden of proof: The government must prove its case against the defendant **beyond a reasonable doubt**. That is, even if it seems very likely that the defendant committed the crime, as long as there remains some reasonable doubt - perhaps he was not clearly identified as the culprit; perhaps he has an alibi that could be legitimate - the jury must vote to acquit rather than convict.

By contrast, the burden of proof in ordinary civil cases - those dealing with contracts, personal injuries, and the like - is a preponderance of the evidence, which means that the plaintiff's evidence must outweigh whatever evidence the defendant can muster that casts doubts on the plaintiff's claim.

This is not merely a matter of counting the number of witnesses or of the length of time that the parties talk: The judge in a trial without a jury (a bench trial), or the jury where one is impaneled, must apply the preponderance of evidence test by determining which side has the greater weight of credible, relevant evidence.

Adjudication and the adversary system imply certain other characteristics of courts. Judges must be impartial; those with a personal interest in a matter must refuse to hear it. The ruling of a court, after all appeals are exhausted, is final.

This principle is known as *res judicata* (Latin for "the thing is decided"), and it means that the same parties may not take up the same dispute in another court at another time. Finally, a court must proceed according to a public set of formal procedural rules; a judge cannot make up the rules as he goes along.



### TERMS TO KNOW

#### **Beyond a Reasonable Doubt**

The standard of proof by which a criminal defendant must be found guilty in order to be convicted of a crime or misdemeanor.

#### **Res Judicata**

A matter that has been adjudicated and finally decided; a rule that once a case is finally decided, it cannot be brought again.

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## 3. Beginning a Lawsuit

Beginning a lawsuit is simple and is spelled out in the rules of procedure by which each court system operates.

### 3a. Complaint and Summons

In the federal system, the plaintiff begins a lawsuit by filing a **complaint** - a document clearly explaining the grounds for suit - with the clerk of the court.

The court's agent (usually a sheriff, for state trial courts, or a U.S. deputy marshal, in federal district courts) will then serve the defendant with the complaint and a summons. The summons is a court document stating the name of the plaintiff and his attorney and directing the defendant to respond to the complaint within a fixed time period.

The timing of the filing can be important. Almost every possible legal complaint is governed by a federal or state statute of limitations, which requires a lawsuit to be filed within a certain period of time.

⇒ **EXAMPLE** In many states, a lawsuit for injuries resulting from an automobile accident must be filed within two years of the accident or the plaintiff forfeits his right to proceed.

As noted earlier, making a correct initial filing in a court that has subject matter jurisdiction is critical to avoiding statute of limitations problems.



#### TERM TO KNOW

##### **Complaint**

The document filed to bring about a lawsuit.

### 3b. Jurisdiction and Venue

The place of filing is equally important, and there are two issues regarding location. The first is subject matter jurisdiction, as already noted.

⇒ **EXAMPLE** A claim for breach of contract, in which the amount at stake is \$1 million, cannot be brought in a local county court with jurisdiction to hear cases involving sums of up to only \$1,000. Likewise, a claim for copyright violation cannot be brought in a state trial court, since federal courts have exclusive jurisdiction over copyright cases.

The second consideration is **venue**— the proper geographic location of the court.

⇒ **EXAMPLE** Every county in a state might have a trial court, but the plaintiff is not free to pick just any county.

Again, a statute will spell out to which court the plaintiff must go (e.g., the county in which the plaintiff resides or the county in which the defendant resides or maintains an office).



#### TERM TO KNOW

##### **Venue**

A particular place, county, or geographical area where a court is located.

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## 4. Service of Process and Personal Jurisdiction



The defendant must be served— that is, must receive notice that he has been sued. Service can be done by physically presenting the defendant with a copy of the summons and complaint. But sometimes the defendant is difficult to find (or deliberately avoids the marshal or other process server).

State procedural rules spell out a variety of ways by which individuals and corporations can be served. These include using U.S. Postal Service certified mail or serving someone already designated to receive **service of process**.

⇒ **EXAMPLE** A corporation or partnership is often required by state law to designate a “registered agent” for purposes of getting public notices or receiving a summons and complaint.

One of the most troublesome problems is service on an out-of-state defendant. The **personal jurisdiction** of a state court over persons is clear for those defendants found within the state.

If the plaintiff claims that an out-of-state defendant injured him in some way, must the plaintiff go to the defendant’s home state to serve him? Unless the defendant had some **significant contact** with the plaintiff’s state, the plaintiff may indeed have to.

⇒ **EXAMPLE** Suppose a traveler from Maine stopped at a roadside diner in Montana and ordered a slice of homemade pie that was tainted and caused him to be sick. The traveler may not simply return home and mail the diner a notice that he is suing it in a Maine court. But if out-of-state defendants have some contact with the plaintiff’s state of residence, there might be grounds to bring them within the jurisdiction of the plaintiff’s state courts.

Again, recall that even if a court has subject matter jurisdiction, it must also have personal jurisdiction over each defendant against whom an enforceable judgment can be made. Often this is not a problem; you might be suing a person who lives in your state or regularly does business in your state.

Or a nonresident may answer your complaint without objecting to the court’s ***in personam*** (personal) jurisdiction. But many defendants who do not reside in the state where the lawsuit is filed would rather not be put to the inconvenience of contesting a lawsuit in a distant forum. Fairness - and the due process clause of the Fourteenth Amendment - dictates that nonresidents should not be required to defend lawsuits far from their home base, especially where there is little or no contact or connection between the nonresident and the state where a lawsuit is brought.

Every state in the United States has a statute regarding personal jurisdiction, instructing judges when it is permissible to assert personal jurisdiction over an out-of-state resident. These are called **long-arm statutes**. But no state can reach out beyond the limits of what is constitutionally permissible under the Fourteenth Amendment, which binds the states with its proviso to guarantee the due process rights of the citizens of every state in the union.



#### TERMS TO KNOW

##### **Service of Process**

The act of serving a defendant with legal process, dictated by the rules of procedure of a particular court.

##### **Personal Jurisdiction**

The authority a court has over a person being sued. The U.S. Constitution requires that in order for a court to have power over a person, that person must have minimum contacts with the forum (geographical area covered by the court). A court lacking personal jurisdiction over someone cannot issue a judgment against that person.

### **Significant Contact**

The requirement for a court's personal jurisdiction over a defendant; such jurisdiction is not permitted where the defendant does not have at least minimum contact with the jurisdiction where the court is located.

### **In Personam**

A Latin term used in law to refer to personal jurisdiction.

### **Long-Arm Statute**

A state law that provides for personal jurisdiction over defendants in foreign states. For example, doing business in a state is one category states have determined allow them to use their "long arm" to require an out-of-state defendant to appear in their court. Therefore, a corporation like Sears, headquartered in one state, may be required to defend actions in other states where it does business.

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## **5. General Rules of Personal Jurisdiction**

When considering the basic rules of personal jurisdiction, refer to the following list:

1. Once a court determines that it has subject matter jurisdiction, it must find at least one defendant over which it is fair (i.e., in accord with due process) to exercise personal jurisdiction.
2. If a plaintiff sues five defendants and the court has personal jurisdiction over just one, the case can be heard, but the court cannot make a judgment against the other four.
  - a. But if the plaintiff loses against defendant 1, he can go elsewhere (to another state or states) and sue defendants 2, 3, 4, or 5.
  - b. The court's decision in the first lawsuit (against defendant 1) does not determine the liability of the nonparticipating defendants.
  - c. This involves the principle of *res judicata*, which means that you can't bring the same action against the same person (or entity) twice. It's like the civil side of double jeopardy. *Res* means "thing," and *judicata* means "adjudicated." Thus the "thing" has been "adjudicated" and should not be judged again. But for nonparticipating parties, it is not over. If you have a different case against the same defendant - one that arises out of a completely different situation - that case is not barred by *res judicata*.
3. Service of process is a necessary (but not sufficient) condition for getting personal jurisdiction over a particular defendant (see rule 4).
  - a. In order to get a judgment in a civil action, the plaintiff must serve a copy of the complaint and a summons to the defendant.
  - b. There are many ways to do this, all set forth in the state's procedural rules.
    - i. The process server personally serves a complaint on the defendant.

- ii. The process server leaves a copy of the summons and complaint at the residence of the defendant, in the hands of a competent person.
  - iii. The process server sends the summons and complaint by certified mail, return receipt requested.
  - iv. The process server, if all other means are not possible, notifies the defendant by publication in a newspaper having a minimum number of readers (as may be specified by law).
4. In addition to successfully serving the defendant with process, a plaintiff must convince the court that exercising personal jurisdiction over the defendant is consistent with due process and any statutes in that state that prescribe the jurisdictional reach of that state (the so-called long-arm statutes). The Supreme Court has long recognized various bases for judging whether such process is fair.
- a. *Consent*: The defendant agrees to the court's jurisdiction by coming to court, answering the complaint, and having the matter litigated there. (Unlike subject matter jurisdiction, which cannot be waived, personal jurisdiction can be waived by an entity or person who may submit him or herself or itself to the court's personal jurisdiction.)
  - b. *Domicile*: The defendant is a permanent resident of that state.
  - c. *Event*: The defendant did something in that state, related to the lawsuit, that makes it fair for the state to say, "Come back and defend!"
  - d. Service of process within the state will effectively provide personal jurisdiction over the nonresident.

#### **CASE STUDY: *World-Wide Volkswagen Corp. v. Woodson***

Again, let's consider Mrs. Robinson and her children in the Audi accident. She could file a lawsuit in Arizona after she establishes residency there. But while the Arizona court would have subject matter jurisdiction over any products-liability claim (or any claim that was not required to be heard in a federal court), the Arizona court would face an issue of personal jurisdiction: Under the due process clause of the Fourteenth Amendment, each state must extend due process to citizens of all of the other states. Because fairness is essential to due process, the court must consider whether it is fair to require an out-of-state defendant to appear and defend against a lawsuit that could result in a judgment against that defendant.

## 6. Choice of Law and Choice of Forum Clauses

To simplify matters, many commercial contracts contain choice of law clauses. Courts honor these terms in a contract and will apply the law of the state chosen by the parties in their contract.

⇒ **EXAMPLE** Suppose the parties to a contract wind up in court arguing over the application of the contract's terms. If the parties are from two different states, the judge may have difficulty determining which law to apply.

If the contract says that a particular state's law will be applied if there is a dispute, then ordinarily the judge will apply that state's law as a rule of decision in the case.

## IN CONTEXT

Let's say that Kumar Patel (a Missouri resident) opens a brokerage account with Goldman, Sachs and Co., and the contractual agreement calls for “any disputes arising under this agreement” to be determined “according to the laws of the state of New York.” When Kumar claims in a Missouri court that his broker is “churning” his account, and, on the other hand, Goldman, Sachs claims that Kumar has failed to meet his margin call and owes \$38,568.25 (plus interest and attorney’s fees), the judge in Missouri will apply New York law based on the contract between Kumar and Goldman, Sachs.

Ordinarily, a choice of law clause will be accompanied by a choice of forum clause. In a choice of forum clause, the parties in the contract specify which court they will go to in the event of a dispute arising under the terms of contract.

## IN CONTEXT

Let's say that Harold (a resident of Virginia) rents a car from Alamo at the Denver International Airport. He does not look at the fine print on the contract. He also waives all collision and other insurance that Alamo offers at the time of his rental. While driving back from Telluride Bluegrass Festival, he has an accident in Idaho Springs, Colorado. His rented Nissan Altima is badly damaged. On returning to Virginia, he would like to settle up with Alamo, but his insurance company and Alamo cannot come to terms. He realizes, however, that he has agreed to hear the dispute with Alamo in a specific court in San Antonio, Texas. In the absence of fraud or bad faith, any court in the United States is likely to uphold the choice of forum clause and require Harold (or his insurance company) to litigate in San Antonio, Texas.



## SUMMARY

In this lesson, you learned that the courts function as part of an **adversary system** in which both sides of a dispute are able to present evidence before a judge. The **method of adjudication** will always mandate a reasoned decision by an impartial judge. Additionally, the plaintiff or prosecution must meet the **burden of proof**.

When **beginning a lawsuit**, the first step is the **complaint and summons** - which involves **service of process** - followed by the determination of **jurisdiction and venue**. There are some **general rules for personal jurisdiction** that can help in determining which court has the power to hear a particular case. Many commercial contracts include **choice of law and choice of forum clauses** that can help simplify the determination of personal jurisdiction.

Best of luck in your learning!

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## TERMS TO KNOW

### **Adversary System**

The legal system in use in the U.S. whereby courts hear evidence from parties in a case who advocate for themselves, while the judge acts as an independent arbiter of the facts and law. Distinguished from the inquisitorial system where the judge investigates.

### **Beyond a Reasonable Doubt**

The standard of proof by which a criminal defendant must be found guilty in order to be convicted of a crime or misdemeanor.

### **Complaint**

The document filed to bring about a lawsuit.

### **In Personam**

A Latin term used in law to refer to personal jurisdiction.

### **Judicial Notice**

The custom allowing a judge to take notice of events that are commonly known, such as the weather or a well-known event, without having to take in evidence of same.

### **Long-Arm Statute**

A state law that provides for personal jurisdiction over defendants in foreign states. For example, doing business in a state is one category states have determined allow them to use their "long arm" to require an out-of-state defendant to appear in their court. Therefore, a corporation like Sears, headquartered in one state, may be required to defend actions in other states where it does business.

### **Personal Jurisdiction**

The authority a court has over a person being sued. The U.S. Constitution requires that in order for a court to have power over a person, that person must have minimum contacts with the forum (geographical area covered by the court). A court lacking personal jurisdiction over someone cannot issue a judgment against that person.

### **Preponderance of the Evidence**

A standard of proof whereby a fact is proven in civil cases; such evidence is of greater weight or more convincing than the evidence offered in opposition to it. Distinguished from "beyond a reasonable doubt," the standard in criminal cases.

### **Res Judicata**

A matter that has been adjudicated and finally decided; a rule that once a case is finally decided, it cannot be brought again.

**Service of Process**

The act of serving a defendant with legal process, dictated by the rules of procedure of a particular court.

**Significant Contact**

The requirement for a court's personal jurisdiction over a defendant; such jurisdiction is not permitted where the defendant does not have at least minimum contact with the jurisdiction where the court is located.

**Venue**

A particular place, county, or geographical area where a court is located.

# The Trial

by Sophia



## WHAT'S COVERED

In this lesson, you will learn the standard structure of trials in the United States legal system.

Specifically, this lesson will cover:

1. Jury Selection
2. Opening Statements and Witness Testimony
3. Cross-Examination and Redirect Examination
4. Judge's Responsibility
5. Directed Verdict and Closing Arguments
6. Jury Instructions
7. Verdict and Post-Trial Motions

## 1. Jury Selection

At trial, the first order of business is to select a jury. In a civil case of any consequence, either party can request one, based on the Sixth Amendment to the U.S. Constitution. The judge and sometimes the lawyers are permitted to question the jurors to be sure that they are unbiased.

This questioning is known as the *voir dire* (pronounced vwahr-DEER). This is an important process, and a great deal of thought goes into selecting the jury. A jury panel can be as few as six persons, or as many as twelve, with alternates selected and sitting in court in case one of the jurors is unable to continue. In a long trial, having alternates is essential; even in shorter trials, most courts will have at least two alternate jurors.

In both criminal and civil trials, each side has opportunities to challenge potential jurors for cause.

### IN CONTEXT

In a case against Audi, the attorneys representing Audi will want to know if any prospective jurors have ever owned an Audi, what their experience has been, and if they had a problem with their Audi that was not resolved to their satisfaction. If so, the defense attorney could well believe that such a juror has a potential for a bias against her client. In that case, she could use a challenge for cause,

explaining to the judge the basis for her challenge. The judge uses discretion to either accept the for-cause reason or reject it.

Even if an attorney cannot articulate a for-cause reason acceptable to the judge, he may use one of several **peremptory challenges** (no reason needed) that most states (and the federal system) allow. A trial attorney with many years of experience may have a sixth sense about a potential juror and, in consultation with the client, may decide to use a peremptory challenge to avoid having that juror on the panel.



#### TERM TO KNOW

##### **Peremptory Challenge**

The right of a party to challenge a juror without giving a reason. This right is limited to a particular number of challenges.

## 2. Opening Statements and Witness Testimony

After the jury is sworn and seated, the plaintiff's lawyer makes an **opening statement**, laying out the nature of the plaintiff's claim, the facts of the case as the plaintiff sees them, and the evidence that the lawyer will present. The defendant's lawyer may also make an opening statement or may reserve his right to do so at the end of the plaintiff's case.

The plaintiff's lawyer then calls witnesses and presents the physical evidence that is relevant to the proof. The direct testimony at trial is usually far from a smooth narration. The **rules of evidence** (that govern the kinds of testimony and documents that may be introduced at trial) and the question-and-answer format tend to make the presentation of evidence choppy and difficult to follow.

#### IN CONTEXT

Anyone who has watched an actual televised trial or a television melodrama featuring a trial scene will appreciate the nature of the trial itself: Witnesses are asked questions about a number of issues that may or may not be related, the opposing lawyer will frequently object to the question or the form in which it is asked, and the jury may be sent from the room while the lawyers argue at the bench before the judge.



#### TERMS TO KNOW

##### **Opening Statement**

The statement each side of a lawsuit makes to a jury to introduce the case.

##### **Rules of Evidence**

Court rules governing the admissibility of evidence at trial.



# 3. Cross-Examination and Redirect Examination

After direct testimony of each witness, the opposing lawyer may conduct **cross-examination**. This is a crucial constitutional right; in criminal cases it is preserved in the Constitution's Sixth Amendment (the right to confront one's accusers in open court).

The formal rules of direct testimony are then relaxed, and the cross-examiner may probe the witness more informally, asking questions that may not seem immediately relevant. This is when the opposing attorney may become harsh, casting doubt on a witness's credibility, trying to trip her up and show that the answers she gave are false or not to be trusted.

This use of cross-examination, along with the requirement that the witness respond to questions that are relevant to the case, distinguishes common-law courts from those of authoritarian regimes around the world.

Following cross-examination, the plaintiff's lawyer may then question the witness again: This is called **redirect examination** and is used to demonstrate that the witness's original answers were accurate and to show that any implications otherwise, suggested by the cross-examiner, were unwarranted.

The cross-examiner may then engage the witness in recross-examination, and so on. The process usually stops after cross-examination or redirect.



## TERMS TO KNOW

### Cross-Examination

A procedure whereby the opposing side is allowed to question the other side's witnesses in a trial or deposition, usually limited in scope by the content of the direct examination in a trial.

### Redirect Examination

The procedure whereby the side that first testified on direct examination is allowed to conduct another examination of a witness limited to matters that came up on cross-examination in a trial.

### Recross-Examination

The procedure whereby the side that performed cross-examination is allowed to conduct another examination of a witness limited to matters that came up on re-direct examination in a trial. There is no limit to how long these processes may continue.

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# 4. Judge's Responsibility

During the trial, the judge's chief responsibility is to see that the trial is fair to both sides. One big piece of that responsibility is to rule on the admissibility of evidence.

⇒ **EXAMPLE** A judge may rule that a particular question is out of order - that is, not relevant or appropriate - or that a given document is irrelevant.

Where the attorney is convinced that a particular witness, a particular question, or a particular document (or part thereof) is critical to the case, he may object to the court's ruling by saying "**objection**," in which case the court stenographer will note the objection.

On appeal, the attorney may cite any number of objections as adding up to the lack of a fair trial for her client and may request a court of appeals to order a retrial. If no objection is made, it is **waived**.

For the most part, courts of appeal will not reverse and remand for a new trial unless the trial court judge's errors are **prejudicial** or an **abuse of discretion**. In short, neither party is entitled to a perfect trial, but only to a fair trial, one in which the trial judge has made only **harmless errors** and not prejudicial ones.



#### TERMS TO KNOW

##### **Objection**

A formal challenge by a party to an offer of evidence or testimony by the opposing side in a trial.

##### **Waiver**

The relinquishment of a right to object to evidence in court if a timely objection is not made.

##### **Prejudicial**

A judge's errors at trial that substantially affect an appellant's legal rights.

##### **Abuse of Discretion**

A judge's failure to exercise sound and reasonable discretion; an error of law by the court.

##### **Harmless Errors**

Errors made by a judge at trial that are deemed not to have any meaningful effect on the appellant's rights.

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## 5. Directed Verdict and Closing Arguments

At the end of the plaintiff's case, the defendant presents his case, following the same procedure just outlined. The plaintiff is then entitled to present **rebuttal** witnesses, if necessary, to deny or disagree with the evidence the defendant has introduced. The defendant in turn may present a rebuttal witnesses.

When all testimony has been introduced, either party may ask the judge for a **directed verdict**— a verdict decided by the judge without advice from the jury.

This motion may be granted if the plaintiff has failed to introduce evidence that is legally sufficient to meet her burden of proof or if the defendant has failed to do the same on issues on which she has the burden of proof.

⇒ **EXAMPLE** Say the plaintiff alleges that the defendant owes him money and introduces a signed promissory note, and the defendant cannot show that the note is invalid. The defendant must lose the case unless he can show that the debt has been paid or otherwise discharged.

The defendant can move for a directed verdict at the close of the plaintiff's case, but the judge will usually wait to hear the entire case until deciding whether to do so. Directed verdicts are not usually granted, since it is the

jury's job to determine the facts in dispute.

If the judge refuses to grant a directed verdict, each lawyer will then present a closing argument to the jury (or, if there is no jury, to the judge alone). The closing argument is used to tie up the loose ends, as the attorney tries to bring together various seemingly unrelated facts into a story that will make sense to the jury.



#### TERMS TO KNOW

##### **Rebuttal**

A witness whose testimony is given for the purpose of contradicting prior evidence, or testimony presented by a witness for the other side in a trial.

##### **Directed Verdict**

A verdict decided by the judge without advice from the jury, often occurring when the plaintiff (or prosecutor in a criminal case) has not presented sufficient evidence

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## 6. Jury Instructions

After **closing arguments**, the judge will instruct the jury. The purpose of jury instruction is to explain to the jurors the meaning of the law as it relates to the issues they are considering and to tell the jurors what facts they must determine if they are to give a verdict for one party or the other.

Each lawyer will have prepared a set of written instructions that she hopes the judge will give to the jury. These will be tailored to advance her client's case. Many a verdict has been overturned on appeal because a trial judge has wrongly instructed the jury.

The judge will carefully determine which instructions to give and often will use a set of pattern instructions provided by the state bar association or the Supreme Court of the state. These pattern jury instructions are often safer because they are patterned after language that appellate courts have used previously, and appellate courts are less likely to find reversible error in the instructions.



#### TERM TO KNOW

##### **Closing Argument**

The concluding statement made by each party to a jury summarizing the evidence, law, and reasons why the jury should find in their favor.

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## 7. Verdict and Post-Trial Motions

After all instructions are given, the jury will retire to a private room and discuss the case and the answers requested by the judge for as long as it takes to reach a unanimous verdict.

Some minor cases do not require a unanimous verdict. If the jury cannot reach a decision, this is called a **hung jury**, and a **mistrial** is declared, requiring the case to be retried. When a jury does reach a verdict, it delivers it in court with both parties and their lawyers present.

The jury is then discharged, and control over the case returns to the judge. If there is no jury, the judge will usually announce in a written opinion his findings of fact and how the law applies to those facts. Juries just announce their verdicts and do not state their reasons for reaching them.

The losing party is allowed to ask the judge for a new trial or for a **judgment notwithstanding the verdict** (often called a judgment n.o.v., from the Latin *non obstante veredicto*). This is called for when a jury fails to apply the law correctly.

Rule 50(b) of the Federal Rules of Civil Procedure called "Judgment as a Matter of Law" provides the authorization for federal judges making a judgment contrary to the judgment of the jury. Most states have a similar rule.



#### TERMS TO KNOW

##### **Hung Jury**

A jury that is unable to agree on a verdict.

##### **Mistrial**

A trial declared to be invalid due to an error in the proceedings.

##### **Judgment Notwithstanding the Verdict**

Also known as judgment n.o.v., a judgment entered by order of court at the end of a proceeding, despite a contrary verdict.



#### SUMMARY

In this lesson, you learned that a trial begins with **jury selection**. Once the proceedings are underway, the plaintiff's lawyer gives an **opening statement** and calls **witnesses to testify**. The defendant's lawyer can **cross-examine** the plaintiff's witnesses, and the plaintiff's lawyer can then respond with a **redirect examination**. After the plaintiff's entire case has been presented, the defendant's lawyer will repeat this process. Either party may request a **directed verdict** which means that the judge will make the final decision instead of the jury. If this does not happen, both sides will give **closing arguments**. The judge will then read the **jury instructions** and the jurors will deliberate until they reach a **verdict**.

The **responsibility of a trial judge** is to ensure justice to all parties to the lawsuit. The judge presides, instructs the jury, and may limit who testifies and what they testify about. In all of this, the judge will usually commit some errors; occasionally these will be the kinds of errors that seriously compromise a fair trial for both parties. Errors that do seriously compromise a fair trial for both parties can result in a **post-trial motion** to overturn the decision.

Best of luck in your learning!

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## TERMS TO KNOW

### **Abuse of Discretion**

A judge's failure to exercise sound and reasonable discretion; an error of law by the court.

### **Closing Argument**

The concluding statement made by each party to a jury summarizing the evidence, law, and reasons why the jury should find in their favor.

### **Cross-Examination**

A procedure whereby the opposing side is allowed to question the other side's witnesses in a trial or deposition, usually limited in scope by the content of the direct examination in a trial.

### **Directed Verdict**

A verdict decided by the judge without advice from the jury, often occurring when the plaintiff (or prosecutor in a criminal case) has not presented sufficient evidence.

### **Harmless Errors**

Errors made by a judge at trial that are deemed not to have any meaningful effect on the appellant's rights.

### **Hung Jury**

A jury that is unable to agree on a verdict.

### **Judgment Notwithstanding the Verdict**

Also known as judgment n.o.v., a judgment entered by order of court at the end of a proceeding, despite a contrary verdict.

### **Mistrial**

A trial declared to be invalid due to an error in the proceedings.

### **Objection**

A formal challenge by a party to an offer of evidence or testimony by the opposing side in a trial.

### **Opening Statement**

The statement each side of a lawsuit makes to a jury to introduce the case.

**Peremptory Challenge**

The right of a party to challenge a juror without giving a reason. This right is limited to a particular number of challenges.

**Prejudicial**

A judge's errors at trial that substantially affect an appellant's legal rights.

**Rebuttal**

A witness whose testimony is given for the purpose of contradicting prior evidence, or testimony presented by a witness for the other side in a trial.

**Recross-Examination**

The procedure whereby the side that performed cross-examination is allowed to conduct another examination of a witness limited to matters that came up on redirect examination in a trial. There is no limit to how long these processes may continue.

**Redirect Examination**

The procedure whereby the side that first testified on direct examination is allowed to conduct another examination of a witness limited to matters that came up on cross-examination in a trial.

**Rules of Evidence**

Court rules governing the admissibility of evidence at trial.

**Waiver**

The relinquishment of a right to object to evidence in court if a timely objection is not made.

# Alternative Dispute Resolution

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about an option for resolving disputes outside of the courts. Specifically, this lesson will cover:

1. Purpose of ADR
2. ADR in the Legal System
3. Types of ADR
  - 3a. Arbitration
  - 3b. Mediation

## 1. Purpose of ADR

A common method of dispute resolution that avoids many of the challenges associated with litigation is **alternative dispute resolution (ADR)**. ADR is a term that encompasses many different methods of dispute resolution other than litigation.

ADR involves resolving disputes outside of the judicial process, though courts can require parties to participate in specific types of ADR, such as arbitration, for some types of conflicts. Some ADR methods vest the power to resolve the dispute in a neutral party, while other strategies vest that power in the parties themselves.

Beginning around 1980, a movement toward alternative dispute resolution began to gain force throughout the United States. Bar associations, other private groups, and the courts themselves wanted to find quicker and cheaper ways for parties to settle disagreements.

As a result, neighborhood justice centers or dispute resolution centers sprang up in communities. Today, most state and federal agencies as well as most courts have a policy that, to save time and money, any dispute must first use ADR to resolve the issue before resorting to litigation.

### IN CONTEXT

Imagine that you've been wronged by a supplier, by your employer, or by a business where you are a customer. You've correctly determined that you have an actionable legal claim. What are you going to do? You probably won't run to the courthouse to file a formal complaint to initiate litigation. This is

because litigation is very expensive and time-consuming. Besides, you may wish to continue doing business with the supplier, employer, or business. Perhaps the matter is of a private nature, and you do not want to engage in a public process to determine the outcome. You would like the dispute to be resolved, but you do not want to engage in public, time-consuming, expensive litigation to do it.

Frequently used types of ADR include negotiation, mediation, and arbitration. Lesser-used methods of ADR include mini-trials, hybrid forms like mediation-arbitration, and collaborative goal-oriented processes.

ADR is often used to resolve disputes among businesses, employers and employees, and businesses and consumers. ADR can also be used in many other types of conflicts.

⇒ **EXAMPLE** ADR strategies can be used in domestic law cases, such as divorce, or in international legal issues, such as issues relating to transboundary pollution. ADR can also be used in disputes between neighbors.



#### TERM TO KNOW

#### **Alternative Dispute Resolution (ADR)**

A means of resolving disputes outside of the judicial process, including but not limited to negotiation, mediation, arbitration, neutral evaluation, conciliation conferences, settlement conferences, and the like.

## 2. ADR in the Legal System

ADR methods are used outside of the courtroom, but that does not mean that they are outside of the interests of our legal system. Participation in ADR has important legal consequences.

#### **IN CONTEXT**

Parties who have agreed by contract to be subject to binding arbitration give up their constitutional right to bring their complaint to court. The Federal Arbitration Act (FAA) is a federal statute under which parties are required to participate in arbitration when they have agreed by contract to do so, even in state court matters.

There is a very good chance that you will - or already have - signed a contract that contains a mandatory arbitration clause. This provision is often contained in the terms of service or other contracts people typically do not read. If a dispute arises under that contract, then you will be required to arbitrate your claim rather than going straight to court. Under a binding arbitration clause, you will have waived your constitutional right to go to court.

Even if you have never signed such a contract and never will, it's important in the business world to understand the ADR process, situations in which litigation is a better choice than ADR, and special issues that arise when



parties have unequal bargaining power.

## 3. Types of ADR

If an initial informal **negotiation** cannot solve the dispute, the parties may use one of two common types of ADR:

- Arbitration
- Mediation



### TERM TO KNOW

#### Negotiation

A form of alternate dispute resolution in which the parties attempt to work directly with each other to resolve a dispute without the use of a third party.

### 3a. Arbitration

**Arbitration** is a process in which the parties use a private decision-maker, the arbitrator, and the rules of procedure are considerably more relaxed than those that apply in the courtroom.

Arbitrators might be retired judges, lawyers, or anyone with the kind of specialized knowledge and training that would be useful in making a final, binding decision on the dispute. In a contractual relationship, the parties can decide even before a dispute arises to use arbitration when the time comes. Or, parties can decide after a dispute arises to use arbitration instead of litigation.

In a contract, the parties can spell out the rules of procedure to be used and the method for choosing the arbitrator.

⇒ **EXAMPLE** Parties may name the specific person or delegate the responsibility of choosing to some neutral person, or they may each designate a person and the two designees may jointly pick a third arbitrator.

Arbitration has two advantages over litigation. First, it is usually much quicker, because the arbitrator does not have a backlog of cases and because the procedures are simpler. Second, in complex cases, the quality of the decision may be higher, because the parties can select an arbitrator with specialized knowledge.

The drawbacks are that the arbitrator has to be paid; whereas, a court trial is typically provided at taxpayer expense, and that when arbitration is binding, it is final and parties lose their rights to appeal unless there was some impropriety committed by the arbitrator or a party.

Under both federal and state laws, arbitration is favored, meaning that if you have agreed to arbitration, you can't go to court if the other party wants you to arbitrate. Under the Federal Arbitration Act, the other party can go to court and get a stay against your litigation and also get an order compelling you to go to arbitration.



### TERM TO KNOW

## Arbitration

A form of alternative dispute resolution in which a neutral third party (the arbitrator) acts as a judge to determine a legally binding solution to the conflict.

### 3b. Mediation

Unlike arbitration, **mediation** gives the neutral party no power to impose a decision. The mediator is a go-between who attempts to help the parties negotiate a solution.

The mediator will communicate the parties' positions to each other, will facilitate the finding of common ground, and will suggest outcomes. But the parties have complete control: They may ignore the recommendations of the mediator entirely, settle in their own way, find another mediator, agree to binding arbitration, or go to court.

Mediation risks the loss of money and time invested in the process if it is not successful in reaching a settlement, but its rewards if the parties are successful are that it is private, much less costly than litigation, preserves relationships, helps parties work together (especially valuable where there is ongoing business), and is tailored to parties' specific needs and interests, particularly the need for self-determination.



#### TERM TO KNOW

### Mediation

A form of alternative dispute resolution in which a trained professional (the mediator) attempts to resolve a dispute by listening to the parties, facilitating discussion, and helping find a solution to the problem.



#### SUMMARY

In this lesson, you learned that litigation is not the only way to resolve disputes— alternative dispute resolution can also be an option. The **purpose of ADR** is to provide a faster, more cost-effective method of resolving disputes than the judicial system can. However, **ADR still has a place in the legal system**, as informal negotiation between the disputants usually comes first, followed by one of two **types of ADR: arbitration or mediation**. While mediation gives the parties complete control, arbitration is final and binding. Once you agree to arbitrate, you will have a final, binding arbitral award that is enforceable through the courts, and courts will almost never allow you to litigate after you have agreed to arbitrate.

Best of luck in your learning!

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**Alternative Dispute Resolution (ADR)**

A means of resolving disputes outside of the judicial process, including but not limited to negotiation, mediation, arbitration, neutral evaluation, conciliation conferences, settlement conferences, and the like.

**Arbitration**

A form of alternative dispute resolution in which a neutral third party (the arbitrator) acts as a judge to determine a legally binding solution to the conflict.

**Mediation**

A form of alternative dispute resolution in which a trained professional (the mediator) attempts to resolve a dispute by listening to the parties, facilitating discussion, and helping find a solution to the problem.

**Negotiation**

A form of alternate dispute resolution in which the parties attempt to work directly with each other to resolve a dispute without the use of a third party.

# What Is Ethics?

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the role of ethics in the legal and business worlds. Specifically, this lesson will cover:

1. Ethics and Morality
2. Individual vs. Organizational Ethics
3. Ethics vs. Law
4. Why Be Ethical?

## 1. Ethics and Morality

Most of those who write about ethics do not make a clear distinction between ethics and morality. The question of what is “right” or “morally correct” or “ethically correct” or “morally desirable” all mean the same thing: Which act is “better” in a moral or ethical sense than some other act?

Some people may speak of morality as something personal, but sometimes view ethics as having wider social implications; others see morality as the subject of a field of study, that field being ethics.

Ethics can be thought of as morality applied to any number of subjects, including journalistic ethics, business ethics, or the ethics of professionals like doctors, attorneys, and accountants. For our purposes here, ethics and morality will be used interchangeably.



### TERM TO KNOW

#### Ethics

Moral principles that govern behavior and conduct.

## 2. Individual vs. Organizational Ethics

People often speak about the ethics or morality of both individuals and corporations and nations. There are clearly differences in the kind of moral responsibility that we can fairly ascribe to corporations and nations; we tend to see individuals as having a soul, or at least a conscience, but there is no general agreement that nations or corporations have either.

Still, our ordinary use of language does point to something significant: If we say that some nations are “evil” and others are “corrupt,” then we make moral judgments about the quality of actions undertaken by governments or people of that nation.

⇒ **EXAMPLE** If North Korea is characterized by the U.S. President as part of an “axis of evil,” or if we conclude that Wells Fargo or Enron acted “unethically” in certain respects, then we are making judgments that their collective actions are morally deficient.

In talking about morality, we often use the word “good;” but that word can be confusing.

### IN CONTEXT

If we say that Microsoft is a “good company,” we may be making a statement about the investment potential of Microsoft stock, or their preeminence in the market, or their ability to win lawsuits or appeals or to influence administrative agencies. Less likely, though possibly, we may be making a statement about the civic virtue and corporate social responsibility of Microsoft. In the first set of judgments, we use the word “good” but mean something other than ethical or moral; only in the second instance are we using the word “good” in its ethical or moral sense.

The word “good” can embrace ethical or moral values, but also nonethical values.

### IN CONTEXT

If you like Daniel and try to convince your friends what a “good guy” he is, they may ask all sorts of questions: Is he good-looking? Well-off? Funny? Athletic? Smart? You could answer all of those questions with a yes, yet your friends would still not know any of Daniel's moral qualities. But if you said that he was honest, caring, forthright, and diligent, volunteered in local soup kitchens, or tithed to the church, many people would see Daniel as having certain ethical or moral qualities. If you said that he keeps the Golden Rule as well as anyone you know, your friends could conclude that he is an ethical person. But if you said that he is “always in control” or “always at the top of his game,” your friends would probably not make inferences or assumptions about his good character or ethics.

There are three key points here:

1. Although morals and ethics are not precisely measurable, people generally have similar reactions about what actions or conduct can rightly be called ethical or moral.
2. As humans, we need and value ethical people and want to be around them.
3. Saying that someone or some organization is law-abiding does not mean the same as saying a person or company is ethical.



**BIG IDEA**

For individuals, it is difficult to recognize an ethical problem, have a clear and usable decision-making process to deal with it, and then have the moral courage to do what's right. All of that is even more difficult within a business organization, where corporate employees vary in their motivations, loyalties, commitments, and character. There is no universally accepted way for developing an organization where employees feel valued, respected, and free to openly disagree; where the actions of top management are crystal clear; and where all the employees feel loyal and accountable to one another.

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## 3. Ethics vs. Law

There is a difference between legal compliance and moral excellence. Few would choose a professional service, health care or otherwise, because the provider had a record of perfect legal compliance, or always following the letter of the law.

There are many professional ethics codes, primarily because people realize that law prescribes only a minimum of morality and does not provide purpose or goals that can mean excellent service to customers, clients, or patients.

Business ethicists have talked for years about the intersection of law and ethics. Simply put, what is legal is not necessarily ethical. Conversely, what is ethical is not necessarily required by law. There are lots of legal maneuvers that are not necessarily ethical; the well-used phrase “legal loophole” suggests as much.



### THINK ABOUT IT

Here are two propositions about business and ethics. Consider whether they strike you as true or whether you would need to know more in order to make a judgment.

*Individuals and organizations have reputations. For an individual, moral reputation is most often tied to others' perceptions of his or her character: Is the individual honest, diligent, reliable, fair, and caring? The reputation of an organization is built on the **goodwill** that suppliers, customers, the community, and employees feel toward it. Although an organization is not a person in the usual sense, the goodwill that people feel about the organization is based on their perception of its better qualities by a variety of stakeholders: customers or clients, suppliers, investors, employees, government officials.*

*The goodwill of an organization is to a great extent based on the actions it takes and on whether the actions are favorably viewed. This goodwill is usually specifically counted in the sale of a business as an asset that the buyer pays for. While it is difficult to place a monetary value on goodwill, a firm's good reputation will generally call for a higher evaluation in the final accounting before the sale. Legal troubles or a reputation for having legal troubles will only lessen the price for a business and will even lessen the value of the company's stock as bad legal news comes to the public's attention.*

Another reason to think about ethics in connection with law is that the laws themselves are meant to express some moral view.

⇒ **EXAMPLE** If there are legal prohibitions against cheating the Medicare program, it is because people have collectively decided that cheating Medicare is wrong. If there are legal prohibitions against assisting someone to commit suicide, it is because there has been a group decision that doing so is immoral. Thus, the law provides some important cues as to what society regards as right or wrong.

Finally, important policy issues that face society are often resolved through law, but it is important to understand the moral perspectives that underlie public debate.

⇒ **EXAMPLE** The continuing controversies over stem-cell research, medical use of marijuana, and abortion illustrate differences in moral perspectives across society.

Some ethical perspectives focus on rights, some on social utility, some on virtue or character, and some on social justice. People adopt one or more of these perspectives, and even if they completely agree with an opponent on the facts, they will not change their views. Fundamentally, the difference comes down to incompatible moral perspectives, a clash of basic values.

These are hot-button issues because society is divided, not so much over facts, but over basic values. Understanding various moral perspectives and values in public policy debates is important, especially when discussing ethics.



#### TERM TO KNOW

##### **Goodwill**

In business, the intangible qualities of a business that give it a good reputation; goodwill is considered to have monetary value.

## 4. Why Be Ethical?

The usual answer is that good ethics is good business. In the long run, businesses that pay attention to ethics as well as law do better; they are viewed more favorably by customers.

But this is a difficult claim to measure scientifically, because “the long run” is an indistinct period of time and because there are as yet no generally accepted criteria by which ethical excellence can be measured. In addition, life is still lived in the short run, and there are many occasions when something short of perfect conduct is a lot more profitable.

#### **IN CONTEXT**

In April of 2010, the BP Deepwater Horizon oil spill occurred in the Gulf of Mexico, causing extensive damage to marine and wildlife habitats, beaches, the environment, and fishing and tourism industries. Eleven people died in the explosion, others were injured, and criminal charges were brought against BP. It was estimated BP spent nearly \$62 billion in court fees, penalties, and clean-up costs. In all, an estimated 184 billion gallons of oil were spilled, and a federal judge found BP to have been “grossly negligent,” favoring speed over safety. Initially, the company’s stock value plunged by 55% of its value, but later recovered.

At the time of the spill, its then-CEO Tony Hayward was quoted as having carelessly said, “There’s no one who wants this over more than I do. I’d like my life back,” causing a wave of negative opinion against the company. Consumers were boycotting and investors were getting frightened, so the company had to take a look at its ethic of short-term profit maximization. Since then, changes have been made, and the company now invests in and promotes “sustainability,” voicing a commitment to the environment and safety.

The market does respond to unethical behavior, and the Arthur Andersen story is even more dramatic.

### IN CONTEXT

A now-defunct major accounting firm, Andersen worked closely with Enron in hiding its various losses through creative accounting measures. Suspiciously, Andersen’s Houston office also did some shredding around the clock, appearing to cover up what it was doing for Enron. A criminal case based on this shredding resulted in a conviction, later overturned by the Supreme Court. But the damage was already done. Even before the conviction, many clients had found other accounting firms that were not under suspicion, and the Supreme Court’s reversal came too late to save the company.

The irony of Andersen as a poster child for overly aggressive accounting practices is that the man who founded the firm built it on integrity and straightforward practices. “Think straight, talk straight” was the company’s motto. Andersen established the company’s reputation for integrity over a hundred years ago by refusing to play numbers games for a potentially lucrative client.

Maximizing profits while being legally and ethically compliant is an important goal for a business. People in an organization need some quality or excellence to strive for.

By focusing on pushing the edge of what is legal, by looking for loopholes in the law that would help create short-term financial gain, companies have often learned that in the long term they are not actually satisfying the market, the shareholders, the suppliers, or the community generally.



### SUMMARY

In this lesson, you learned that **ethics and morality** can carry **different responsibilities for organizations and individuals**. Additionally, **legal compliance is not the same as acting ethically**; what is considered "right" by society is not always enforced by the law. **Individuals and businesses should be ethical** because so much of one's reputation depends on how others regard one's actions. Goodwill is hard to measure or quantify.

Best of luck in your learning!



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## TERMS TO KNOW

### **Ethics**

Moral principles that govern behavior and conduct.

### **Goodwill**

In business, the intangible qualities of a business that give it a good reputation; goodwill is considered to have monetary value.

# Major Ethical Perspectives

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about several ways of looking at ethical issues. Specifically, this lesson will cover:

### 1. Utilitarianism

#### 1a. Utilitarianism in Practice

### 2. Deontology

#### 2a. Deontology in Practice

### 3. Social Justice Theory

### 4. Social Contract Theory

### 5. Communitarianism

### 6. Aristotle and Virtue Theory

## 1. Utilitarianism

**Utilitarianism** is a popular perspective on ethics, one that is well aligned with economics and the free-market outlook that has come to dominate much current thinking about business, management, and economics. Jeremy Bentham is often considered the founder of utilitarianism, though John Stuart Mill (who wrote "On Liberty and Utilitarianism") and others promoted it as a guide to what is good.

Utilitarianism emphasizes not rules but results. An action (or set of actions) is generally deemed good or right if it maximizes happiness or pleasure throughout society. Originally intended as a guide for legislators charged with seeking the greatest good for society, the utilitarian outlook may also be practiced individually and by corporations.

Bentham believed that the most promising way to obtain agreement on the best policies for a society would be to look at the various policies a legislature could pass and compare the good and bad consequences of each. The right course of action from an ethical point of view would be to choose the policy that would produce the greatest amount of utility, or usefulness.

In brief, the utilitarian principle holds that an action is right if and only if the sum of utilities produced by that action is greater than the sum of utilities from any other possible act. This statement describes "act

utilitarianism”— which action among various options will deliver the greatest good to society? **Rule utilitarianism** is a slightly different version; it asks, what rule or principle, if followed regularly, will create the greatest good?

Notice that the emphasis is on finding the best possible results and that the assumption is that we can measure the utilities involved. This turns out to be more difficult than you might think. "The sum total of utilities" clearly implies that in doing utilitarian analysis, we cannot be satisfied if an act or set of acts provides the greatest utility to us as individuals or to a particular corporation; the test is, instead, whether it provides the greatest utility to society as a whole.

Also notice that the theory does not tell us what kinds of utilities may be better than others or how much better a good today is compared with a good a year from today.



#### TERMS TO KNOW

##### **Utilitarianism**

A doctrine in the study of ethics that considers actions that are useful or most beneficial to the majority to be the right actions (as opposed to other doctrines that consider the acts themselves in isolation from their utility or benefits).

##### **Rule Utilitarianism**

A form of utilitarianism that looks at a rule and determines its rightness based on utilitarian principles that consider its usefulness.

## **1a. Utilitarianism in Practice**

Whatever its difficulties, utilitarian thinking is alive and well in U.S. law and business. It is found in such diverse places as:

- Cost-benefit analysis in administrative and regulatory rules and calculations
- Environmental impact studies
- The majority vote
- Product comparisons for consumer information
- Marketing studies
- Tax laws
- Strategic planning

In management, people will often employ a form of utility reasoning by projecting costs and benefits for plan X versus plan Y. But the issue is that most of these cost-benefit analyses are usually put exclusively in terms of money and/or directed to the benefit of the person or organization doing the analysis and not to the benefit of society as a whole.

An individual or a company that consistently uses the test “What’s the greatest good for me or the company?” is not following the utilitarian test of the greatest good overall. Another common failing is to see only one or two options that seem reasonable.

The following are some frequent mistakes that people make in applying what they think are utilitarian principles in justifying their chosen course of action:

1. Failing to come up with lots of options that seem reasonable and then choosing the one that has the greatest benefit for the greatest number. Often, a decision maker seizes on one or two alternatives without thinking carefully about other courses of action. If the alternative does more good than harm, the decision maker assumes it's ethically okay.
2. Assuming that the greatest good for you or your company is in fact the greatest good for all. This means you are looking at situations subjectively or with your own interests primarily in mind.
3. Underestimating the costs of a certain decision to you or your company.

#### IN CONTEXT

The now-classic Ford Pinto case demonstrates how Ford Motor Company executives drastically underestimated the legal costs of not correcting a feature on their Pinto models that they knew could cause death or injury. General Motors was often taken to task by juries that came to understand that the company would not recall or repair known and dangerous defects because it seemed more profitable not to. In 2010, Toyota learned the same lesson.

4. Underestimating the cost or harm of a certain decision to someone else or some other group of people.
5. Favoring short-term benefits, even though the long-term costs are greater.
6. Assuming that all values can be reduced to money. In comparing the risks to human health or safety against, say, the risks of job or profit losses, cost-benefit analyses will often try to compare apples to oranges and put arbitrary numerical values on human health and safety.

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## 2. Deontology

In contrast to the utilitarian perspective, **deontology** - presented in the writings of Immanuel Kant - purports that having a moral intent and following the right rules is a better path to ethical conduct than achieving the right results.

A deontologist like Kant is likely to believe that ethical action arises from doing one's duty and that duties are defined by rational thought. Duties, according to Kant, are not specific to particular kinds of human beings but are owed universally to all human beings.

Kant therefore uses "universalizing" as a form of rational thought that assumes the inherent equality of all human beings. It considers all humans as equal, not in the physical, social, or economic sense, but equal before God, regardless of their gender, age, race, sexual orientation, or religion.

For Kantian thinkers, this basic principle of equality means that we should be able to universalize any particular law or action to determine whether it is ethical.

⇒ **EXAMPLE** If you were to consider misrepresenting yourself on a resume for a particular job you really wanted and you were convinced that doing so would get you that job, you might be very tempted to do so. “What harm would it be?” you might ask yourself. “When I have the job, I can prove that I was perfect for it, and no one is hurt, while both the employer and I are clearly better off as a result!”

Kantian ethicists would answer that your chosen course of action should be a universal one— a course of action that would be good for all persons at all times.



#### TERM TO KNOW

### Deontology

A doctrine in the study of ethics that looks at an action in isolation to determine if it is right or wrong, as opposed to looking only at its consequences.

## 2a. Deontology in Practice

There are two requirements for a rule of action to be universal:

- Reversibility
- Consistency

Consider reversibility: If you make a decision as though you didn’t know what role or position you would have after the decision, you would more likely make an impartial one— you would more likely choose a course of action that would be most fair to all concerned, not just you.

Again, deontology requires that we put duty first, act rationally, and give moral weight to the inherent equality of all human beings.

⇒ **EXAMPLE** In considering whether to lie on your resume, reversibility requires you to actively imagine both that you were the employer in this situation and that you were another well-qualified applicant who lost the job because someone else padded his resume with false accomplishments. If the consequences of such an exercise of the imagination are not appealing to you, your action is probably not ethical.

The second requirement for an action to be universal is the search for consistency. This is more abstract. A deontologist would say that since you know you are telling a lie, you must be willing to say that lying, as a general, universal phenomenon, is acceptable.

But if everyone lied, then there would be no point to lying, since no one would believe anyone. It is only because honesty works well for society as a whole and is generally practiced that lying even becomes possible! That is, lying cannot be universalized, for it depends on the preexistence of honesty.

Similar demonstrations can be made for actions such as polluting, breaking promises, and committing most types of crime. But these are the easy cases for Kantian thinkers. In the gray areas of life as it is lived, the consistency test is often difficult to apply.

⇒ **EXAMPLE** If breaking a promise would save a life, then Kantian thought becomes difficult to apply. If some amount of pollution can allow employment and the harm is minimal or distant, Kantian thinking is not all that helpful.

Finally, it should be noted that the well-known Golden Rule, “Do unto others as you would have them do unto you,” emphasizes the easier of the two universalizing requirements: practicing reversibility (“How would I like it if someone did this to me?”).

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## 3. Social Justice Theory

**Social justice** theorists worry about “distributive justice,” or the fair way to distribute goods among a group of people. Marxist thought emphasizes that members of society should be given goods according to their needs.

But this redistribution would require a governing power to decide who gets what and when. It also requires taking something from someone else to get the goods in the first place. Capitalist thought takes a different approach, rejecting any giving that is not voluntary.

Certain economists, such as the late Milton Friedman, also reject the notion that a corporation has a duty to give to unmet needs in society, believing that the government should play that role. Even the most dedicated free-market capitalist will often admit the need for some government intervention and forms of welfare, such as Social Security, Medicare, assistance to flood-stricken areas, along with some public goods (such as defense, education, highways, parks, and support of key industries affecting national security).

People who do not see the need for public goods (including laws, court systems, and the government goods and services just cited) often question why there needs to be a government at all. One response might be, “Without government, there would be no corporations.” Thomas Hobbes believed that people in a “state of nature” would rationally choose to have some form of government. He called this the social contract, where people give up certain rights to government in exchange for security and common benefits.

In your own life and in this course, you will see an ongoing balancing act between human desires for freedom and human desires for order; it is an ancient tension. Some commentators also see a kind of social contract between corporations and society; in exchange for perpetual duration and limited liability, the corporation has some corresponding duties toward society.

Also, if a corporation is legally a “person,” as the Supreme Court reaffirmed in 2010, then some would argue that if this corporate person commits three felonies, it should be locked up for life and its corporate charter revoked.



### TERM TO KNOW

#### **Social Justice**

A doctrine in the study of ethics that considers distribution of wealth, privileges, and opportunities in a society rather than the good of individuals.

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## 4. Social Contract Theory

Modern social contract theorists, such as Thomas Donaldson and Thomas Dunfee, observe that various communities, not just nations, make rules for the common good.

Your college or school is a community, and there are communities within the school (fraternities, sororities, the folks behind the counter at the library circulation desk, the people who work together at the university radio station, the sports teams, the faculty, the students) that have rules, norms, or standards that people can buy into or not. If not, they can exit from that community, just as we are free (though not without cost) to reject U.S. citizenship and take up residence in another country.

Donaldson and Dunfee's integrative social contract theory stresses the importance of studying the rules of smaller communities along with the larger social contracts made in states (such as Colorado or California) and nation-states (such as the United States or Germany). Our Constitution can be seen as a fundamental social contract.

It is important to realize that a social contract can be changed by the participants in a community, just as the U.S. Constitution can be amended. Social contract theory is thus dynamic— it allows for structural and organic changes. Ideally, the social contract struck by citizens and the government would allow for certain fundamental rights such as those we enjoy in the United States, but it need not.

People can give up freedom-oriented rights (such as the right of free speech or the right to be free of unreasonable searches and seizures) to secure order (freedom from fear, freedom from terrorism).

⇒ **EXAMPLE** Many citizens in Russia now miss the days when the Kremlin was all powerful; there was less crime and more equality and predictability to life in the Soviet Union, even if there was less freedom. Thus, the rights that people have in positive law come from whatever social contract exists in the society. This view differs from that of the deontologists and that of the natural-law thinkers such as Gandhi, Jesus, or Martin Luther King Jr., who believed that rights come from God or, in less religious terms, from some transcendent moral order.

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## 5. Communitarianism

Another important movement in ethics and society is **communitarianism**. Communitarians emphasize that rights carry with them corresponding duties; that is, there cannot be a right without a duty.

Interested students may wish to explore the work of Amitai Etzioni. Etzioni was a founder of the Communitarian Network, which is a group of individuals who have come together to bolster the moral, social, and political environment. It claims to be nonsectarian, nonpartisan, and international in scope.

The relationship between rights and duties - in both law and ethics - calls for some explanations:

1. *If you have a right of free expression, the government has a duty to respect that right but can put reasonable limits on it.*

⇒ **EXAMPLE** You can legally say whatever you want about the U.S. President, but you can't get away with threatening the President's life. Even if your criticisms are strong and insistent, you have the right (and our

government has the duty to protect your right) to speak freely. In Singapore during the 1990s, even indirect criticisms of the political leadership were enough to land you in jail or at least silence you with a libel suit.

2. Rights and duties exist not only between people and their governments, but also between individuals.

⇒ **EXAMPLE** Your right to be free from physical assault is protected by the law, and when someone walks up to you and punches you in the nose, your rights - as set forth in the positive law of your state - have been violated. Thus, other people have a duty to respect your rights and to not punch you in the nose.

3. Your right in legal terms is only as good as your society's willingness (and duty) to provide legal remedies through the courts and political institutions of society.

A distinction between basic rights and nonbasic rights may also be important. Basic rights may include such fundamental elements as food, water, shelter, and physical safety.

Another distinction is between positive rights (the right to bear arms, the right to vote, the right of privacy) and negative rights (the right to be free from unreasonable searches and seizures, the right to be free of cruel or unusual punishments).

Yet another is between economic or social rights (adequate food, work, and environment) and political or civic rights (the right to vote, the right to equal protection of the laws, the right to due process).



#### TERM TO KNOW

##### **Communitarianism**

A doctrine that emphasizes the effects of community and society on an individual's development, de-emphasizing individualism.

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## 6. Aristotle and Virtue Theory

**Virtue theory**, or virtue ethics, has received increasing attention over the past twenty years, particularly in contrast to utilitarian and deontological approaches to ethics. Virtue theory emphasizes the value of virtuous qualities rather than formal rules or useful results.

Aristotle is often recognized as the first philosopher to advocate the ethical value of certain qualities, or virtues, in a person's character. Aristotle believed that all activity was aimed at some goal or perceived good and that there must be some ranking that we do among those goals or goods.

Happiness may be our ultimate goal, but what does that mean, exactly? Aristotle rejected wealth, pleasure, and fame, and embraced reason as the distinguishing feature of humans, as opposed to other species. And since a human is a reasoning animal, happiness must be associated with reason. Thus, happiness is living according to the active (rather than passive) use of reason. The use of reason leads to excellence, and so happiness can be defined as the active, rational pursuit of personal excellence, or virtue.

Aristotle named fourteen virtues:

1. Courage, particularly in battle



2. Temperance, or moderation in eating and drinking
3. Liberality, or spending money well
4. Magnificence, or living well
5. Pride, or taking pleasure in accomplishments and stature
6. High-mindedness, or concern with the noble rather than the petty
7. Unnamed virtue, which is halfway between ambition and total lack of effort
8. Gentleness, or concern for others
9. Truthfulness
10. Wit, or pleasure in group discussions
11. Friendliness, or pleasure in personal conduct
12. Modesty, or pleasure in personal conduct
13. Righteous indignation, or getting angry at the right things in the right amounts
14. Justice

From a modern perspective, some of these virtues seem old-fashioned or even odd. Magnificence, for example, is not something we commonly speak of. Three issues emerge:

1. How do we know what a virtue is these days?
2. How useful is a list of agreed-upon virtues anyway?
3. What do virtues have to do with companies, particularly large ones where various groups and individuals may have little or no contact with other parts of the organization?

As to the third question, whether corporations can “have” virtues or values is a matter of lively debate. A corporation is obviously not the same as an individual. But there seems to be growing agreement that organizations do differ in their practices and that these practices are value driven. If all a company cares about is the bottom line, other values will diminish or disappear.

Quite a few books have been written in the past twenty years that emphasize the need for businesses to define their values in order to be competitive in today’s global economy.



#### TERM TO KNOW

##### Virtue Theory

A theory in the study of ethics that emphasizes character and virtue over duties or consequences of actions. Examples are Aristotle’s virtues of integrity, empathy, warmth, courage, conscientiousness, and zeal.



#### SUMMARY

In this lesson, you learned that throughout history, people have pondered what it means to “do what is right.” Some of the main answers have come from the differing perspectives of ethical thought.

**Utilitarianism** is a perspective that values actions producing the greatest good for the greatest number of people. **Utilitarianism in practice** can involve activities like cost/benefit analyses, majority votes, and strategic planning. **Deontology** is a perspective that values moral intent over results. **Deontology in practice** involves the application of consistency and reversibility.

**Social justice theory, social contract theory, and communitarianism** all focus on society at large. Social justice theory is concerned with the fair distribution of resources, while social contract theory looks at how the rules adapted by smaller communities can be beneficial at a more global level.

Communitarianism is the belief that all rights carry certain responsibilities with them. Finally, **virtue theory**, often attributed to **Aristotle**, places more importance on practicing virtuous qualities than following set rules.

Best of luck in your learning!

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## TERMS TO KNOW

### Communitarianism

A doctrine that emphasizes the effects of community and society on an individual's development, de-emphasizing individualism.

### Deontology

A doctrine in the study of ethics that looks at an action in isolation to determine if it is right or wrong, as opposed to looking only at its consequences.

### Rule Utilitarianism

A form of utilitarianism that looks at a rule and determines its rightness based on utilitarian principles that consider its usefulness.

### Social Justice

A doctrine in the study of ethics that considers distribution of wealth, privileges, and opportunities in a society rather than the good of individuals.

### Utilitarianism

A doctrine in the study of ethics that considers actions that are useful or most beneficial to the majority to be the right actions (as opposed to other doctrines that consider the acts themselves in isolation from their utility or benefits).

### Virtue Theory

A theory in the study of ethics that emphasizes character and virtue over duties or consequences of actions. Examples are Aristotle's virtues of integrity, empathy, warmth, courage, conscientiousness, and zeal.

# An Ethical Decision Model

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about a model that can be used to help you make ethical decisions.

Specifically, this lesson will cover:

1. Josephson's Core Values Model
2. The Core Values

## 1. Josephson's Core Values Model

Once you recognize that there is a decision that involves ethical judgment, Michael Josephson would first have you ask as many questions as are necessary to get a full background on the relevant facts.

Then, assuming you have all the needed information, the decision process for **Josephson's core values model** is as follows:



### STEP BY STEP

1. Identify the stakeholders. That is, who are the potential gainers and losers in the various decisions that might be made here?
2. Identify several likely or reasonable decisions that could be made.
3. Consider which stakeholders gain or lose with each decision.
4. Determine which decision satisfies the greatest number of core values.
5. If there is no decision that satisfies the greatest number of core values, try to determine which decision delivers the greatest good to the various stakeholders.

It is often helpful to identify who (or what group) is the most important stakeholder, and why. In economist Milton Friedman's view, it will always be the shareholders. In the view of John Mackey, the CEO of Whole Foods Market, the long-term viability and profitability of the organization may require that customers come first, or, at times, some other stakeholder group.



### TERM TO KNOW

## Josephson's Core Values Model

A process to arrive at the most ethical option for an individual or a business organization, using a virtue ethics approach combined with some elements of stakeholder analysis and utilitarianism.

# 2. The Core Values

Here are the core values and their subcomponents as developed by the Josephson Institute of Ethics.

Value	Subcomponents
Trustworthiness	<p>Be honest: Tell the truth, the whole truth, and nothing but the truth; be sincere, forthright; don't deceive, mislead, or be tricky with the truth; don't cheat or steal, and don't betray a trust.</p> <p>Demonstrate integrity: Stand up for what you believe, walk the walk as well as talking the talk; be what you seem to be; show commitment and courage.</p> <p>Be loyal: Stand by your family, friends, coworkers, community, and nation; be discreet with information that comes into your hands; don't spread rumors or engage in harmful gossip; don't violate your principles just to win friendship or approval; don't ask a friend to do something that is wrong.</p> <p>Keep promises: Keep your word, honor your commitments, and pay your debts; return what you borrow.</p>
Respect	<p>Judge people on their merits, not their appearance; be courteous, polite, appreciative, and accepting of differences; respect others' right to make decisions about their own lives; don't abuse, demean, or mistreat anyone; don't use, manipulate, exploit, or take advantage of others.</p>
Responsibility	<p>Be accountable: Think about the consequences on yourself and others likely to be affected before you act; be reliable; perform your duties; take responsibility for the consequences of your choices; set a good example and don't make excuses or take credit for other people's work.</p> <p>Pursue excellence: Do your best, don't quit easily, persevere, be diligent, make all you do worthy of pride.</p> <p>Exercise self-restraint: Be disciplined, know the difference between what you have a right to do and what is right to do.</p>
Fairness	<p>Treat all people fairly, be open-minded; listen; consider opposing viewpoints; be consistent; use only appropriate considerations; don't let personal feelings improperly interfere with</p>

	decisions; don't take unfair advantage of mistakes; don't take more than your fair share.
Caring	Show you care about others through kindness, sharing, compassion, and empathy; treat others the way you want to be treated; don't be selfish, mean, cruel, or insensitive to others' feelings.
Citizenship	Play by the rules, obey laws; do your share, respect authority, stay informed, vote, protect your neighbors, pay your taxes; be charitable, help your community; protect the environment, conserve resources.

When individuals and organizations confront ethical problems, the core values decision model offered by Josephson generally works well to:

1. Clarify the gains and losses of the various stakeholders, which then raises ethical awareness on the part of the decision maker.
2. Provide a fairly reliable guide as to what the most ethical decision would be. In nine out of ten cases, step five in the decision process is not needed.

That said, it does not follow that students (or managers) would necessarily act in accord with the results of the core values decision process. There are many psychological pressures and organizational constraints that place limits on people both individually and in organizations. These pressures and constraints tend to compromise ideal - or the most ethical - solutions for individuals and for organizations.

For a business, one essential problem is that ethics can cost the organization money or resources, at least in the short term. Doing the most ethical thing will often appear to be something that fails to maximize profits in the short term or that may seem pointless because if you or your organization acts ethically, others will not, and society will be no better off, anyway.



## SUMMARY

In this lesson, you learned about **Josephson's core values model**, a five-step ethical decision model that is designed to help you arrive at the personal or business decision that will satisfy the greatest number of values. **The core values** at the center of the model are trustworthiness, respect, responsibility, fairness, caring, and citizenship.

Best of luck in your learning!

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## TERMS TO KNOW

**Josephson's Core Values Model**

A process to arrive at the most ethical option for an individual or a business organization, using a virtue ethics approach combined with some elements of stakeholder analysis and utilitarianism.

# Corporate Governance

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about the legal and ethical responsibilities of corporations. Specifically, this lesson will cover:

1. Legal Organization of Corporations
2. Duty to Maximize Profits
3. Stakeholder Theory

## 1. Legal Organization of Corporations

As you learned in a previous lesson, corporations involve **shareholders**, **directors**, and **officers**. Shareholders elect directors, who then hire officers to manage the company.

From this structure, some very basic realities follow. Because the directors of a corporation do not meet that often, it's possible for the officers hired (top management, or the "C-suite") to be selective of what the board knows about, and directors are not always ready and able to provide the oversight that the shareholders would like. Nor does the law require officers to be shareholders, so that officers' motivations may not align with the best interests of the company.

This is the "agency problem" often discussed in corporate governance: how to get officers and other top management to align their own interests with those of the shareholders.

⇒ **EXAMPLE** A CEO might trade insider information to the detriment of the company's shareholders. Even board members are susceptible to misalignment of interests.

⇒ **EXAMPLE** Board members might resist hostile takeover bids because they would likely lose their **perks** (short for perquisites) as directors, even though the tender offer would benefit shareholders.

Among other attempted realignments, the use of **stock options** was an attempt to make managers more attentive to the value of company **stock**, but the law of unintended consequences was in full force; managers tweaked and managed earnings in the bubble of the 1990s bull market, and "managing by numbers" became an epidemic in corporations organized under U.S. corporate law.

The rights of shareholders can be bolstered by changes in state and federal law, and there have been some attempts to do that since the late 1990s. But as owners, shareholders have the ultimate power to replace nonperforming or underperforming directors, which usually results in changes at the C-suite level as well.



**Shareholders**

The individuals or entities who own shares of stock in a corporation. They have the right to vote to influence actions of the corporation.

**Directors**

The individuals who make up a corporation's board of directors. They are elected by the shareholders and are legally required to supervise the activities of the corporation as fiduciaries.

**Officers**

The individuals appointed by a corporation's board of directors to be in charge of a corporation as fiduciaries. Officers have a duty of loyalty to the corporation and the authority to make day to day decisions to manage the corporation and delegate authority.

**Perks**

Also known as perquisites; the incidental benefits that come with a job, such as travel opportunities, an expense account, a company car, and the like.

**Stock**

A share of a corporation.

**Stock Option**

A purchased privilege (but not an obligation) to buy a stock at a certain price within a prescribed period of time.

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## 2. Duty to Maximize Profits

There are two main views about what the corporation's duties are. The first view - maximizing profits - is the prevailing view among business managers and in business schools. This view largely follows the idea of Milton Friedman that the duty of a manager is to maximize return on investment to the owners.

In essence, managers' legally prescribed duties are those that make their employment possible. In terms of the legal organization of the corporation, the shareholders elect directors who hire managers, who have legally prescribed duties toward both directors and shareholders.

Those legally prescribed duties are a reflection of the fact that managers are managing other people's money and have a moral duty to act as a responsible agent for the owners. In law, this is called the manager's **fiduciary** duty. Directors have the same duties toward shareholders. Friedman emphasized the primacy of this duty in his writings about corporations and social responsibility, as shown in the excerpts below.

**"The Social Responsibility of Business Is to Increase Its Profits"**

Milton Friedman, *New York Times Magazine*, September 13, 1970

What does it mean to say that “business” has responsibilities? Only people can have responsibilities. A corporation is an artificial person and, in this sense, may have artificial responsibilities, but “business” as a whole cannot be said to have responsibilities, even in this vague sense....

Presumably, the individuals who are to be responsible are businessmen, which means individual proprietors or corporate executives.... In a free enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom....

...[T]he manager is that agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them...

Of course, the corporate executive is also a person in his own right. As a person, he may have other responsibilities that he recognizes or assumes voluntarily—to his family, his conscience, his feeling of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job... But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are “social responsibilities,” they are the social responsibilities of individuals, not of business.

What does it mean to say that the corporate executive has a “social responsibility” in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he has to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire “hardcore” unemployed instead of better qualified available workmen to contribute to the social objective of reducing poverty.

In each of these cases, the corporate executive would be spending someone else’s money for a general social interest. Insofar as his actions... reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers’ money. Insofar as his actions lower the wages of some employees, he is spending their money.

This process raises political questions on two levels: principle and consequences. On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. We have established elaborate constitutional, parliamentary, and judicial provisions to control these functions, to assure that taxes are imposed so far as possible in accordance with the preferences and desires of the public....

Others have challenged the notion that corporate managers have no real duties except toward the owners (shareholders). By changing two letters in *shareholder*, stakeholder theorists widened the range of people and institutions that a corporation should pay moral consideration to. Thus,

they contend that a corporation, through its management, has a set of responsibilities toward non-shareholder interests.



#### TERM TO KNOW

##### **Fiduciary**

An individual who is given a high degree of authority and of whom is demanded a very high level of loyalty and trust. Examples include officers and directors of corporations, bank officers who handle money that is not their own, and trustees of funded organizations.

## 3. Stakeholder Theory

**Stakeholders** (distinct from shareholders who are also called stockholders because they own stock) of a corporation include its employees, suppliers, creditors, contractors, customers, and the community.

Stakeholder is a deliberate play on the word shareholder, to emphasize that corporations have obligations that extend beyond the bottom-line aim of maximizing profits. A stakeholder is anyone who most would agree is significantly affected (positively or negatively) by the decision of another moral agent.

There is one vital fact about corporations: The corporation is a creation of the law. Without law (and government), corporations would not have existence. The key concept for corporations is the legal fact of limited liability. The benefit of limited liability for shareholders of a corporation (meaning shareholders are not liable for corporate wrongdoing) meant that larger pools of capital could be aggregated for larger enterprises; shareholders could only lose their investments should the venture fail in any way, and there would be no personal liability and thus no potential loss of personal assets other than the value of the corporate stock.

Before New Jersey and Delaware competed to make incorporation as easy as possible and beneficial to the incorporators and founders, those who wanted the benefits of incorporation had to go to legislatures - usually among the states - to show a public purpose that the company would serve.

#### IN CONTEXT

In the late 1800s, New Jersey and Delaware changed their laws to make incorporating relatively easy. These two states allowed incorporation “for any legal purpose,” rather than requiring some public purpose. Thus, it is government (and its laws) that make limited liability happen through the corporate form. That is, only through the consent of the state and armed with the charter granted by the state can a corporation’s shareholders have limited liability.

This is a right granted by the state, a right granted for good and practical reasons for encouraging capital and innovation. But with this right comes a related duty, not clearly stated at law, but assumed

when a charter is granted by the state: that the corporate form of doing business is legal because the government feels that it socially useful.

Implicitly, then, there is a social contract between governments and corporations: As long as corporations are considered socially useful, they can exist. But do they have explicit social responsibilities? Milton Friedman's position suggests that having gone along with legal duties, the corporation can ignore any other social obligations. But there are others (such as advocates of stakeholder theory) who would say that a corporation's social responsibilities go beyond just staying within the law and go beyond the corporation's shareholders to include a number of other important stakeholders, those whose lives can be affected by corporate decisions.

According to stakeholder theorists, corporations (and other business organizations) must pay attention not only to the bottom line, but also to their overall effect on the community. Public perception of a company's unfairness, uncaring, disrespect, or lack of trustworthiness often leads to long-term failure, whatever the short-term successes or profits may be. A socially responsible corporation is likely to consider the impact of its decisions on a wide range of stakeholders, not just shareholders.

As the table below indicates, stakeholders have very different kinds of interests ("stakes") in the actions of a corporation.

Stake	Description	Stakeholders
<i>Ownership</i>	The value of the organization has a direct impact on the wealth of these stakeholders.	Managers  Directors who own stock
<i>Economic dependence</i>	Stakeholders can be economically dependent without having ownership. Each of these stakeholders relies on the corporation in some way for financial well-being.	Salaried managers  Creditors  Suppliers  Employees  Local communities
<i>Social interests</i>	These stakeholders are not directly linked to the organization, but have an interest in making sure the organization acts in a socially responsible manner.	Communities  Government  Media



#### TERM TO KNOW

## Stakeholders

A general term referring to persons or organizations who have an interest in a particular matter. For example, the stakeholders interested in whether or not a bar or liquor store can be located in a particular location would be workers, businesses, the community at large, the owner of the proposed business, and law enforcement.



## SUMMARY

In this lesson, you learned that the **legal organization of corporations** consists of shareholders who elect directors, who then hire officers to manage the business. One view of corporate responsibility is the **duty to maximize profits**, which argues that managers have a responsibility to act in the best financial interests of the company. Another view of corporate responsibility is **stakeholder theory**, which argues that both financial gain and a good reputation in the community are company responsibilities.

Best of luck in your learning!

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## TERMS TO KNOW

### Directors

The individuals who make up a corporation's board of directors. They are elected by the shareholders and are legally required to supervise the activities of the corporation as fiduciaries.

### Fiduciary

An individual who is given a high degree of authority and of whom is demanded a very high level of loyalty and trust. Examples include officers and directors of corporations, bank officers who handle money that is not their own, and trustees of funded organizations.

### Officers

The individuals appointed by a corporation's board of directors to be in charge of a corporation as fiduciaries. Officers have a duty of loyalty to the corporation and the authority to make day to day decisions to manage the corporation and delegate authority.

### Perks

Also known as perquisites; the incidental benefits that come with a job, such as travel opportunities, an expense account, a company car, and the like.

### Shareholders

The individuals or entities who own shares of stock in a corporation. They have the right to vote to influence actions of the corporation.

**Stakeholders**

A general term referring to persons or organizations who have an interest in a particular matter. For example, the stakeholders interested in whether or not a bar or liquor store can be located in a particular location would be workers, businesses, the community at large, the owner of the proposed business, and law enforcement.

**Stock**

A share of a corporation.

**Stock Option**

A purchased privilege (but not an obligation) to buy a stock at a certain price within a prescribed period of time.

# Corporate Culture and Codes of Ethics

by Sophia



## WHAT'S COVERED

In this lesson, you will learn more about the role of ethics in corporate environments. Specifically, this lesson will cover:

1. Observations on Corporate Culture
  - 1a. Ethical Leadership Is Top-Down
  - 1b. Accountability Is Often Weak
  - 1c. Killing the Messenger
2. Ethics Codes
3. Federal Sentencing Guidelines
4. Managing by the Numbers
5. Conscious Capitalism

## 1. Observations on Corporate Culture

A corporation is a “person” capable of suing, being sued, and having rights and duties in our legal system. (It is a legal person, not a natural person, according to our Supreme Court.)

Moreover, many corporations have distinct cultures and beliefs that are lived and breathed by their members. Often, the **corporate culture** is the best defense against individuals within that firm who may be tempted to break the law or commit serious ethical misdeeds.

What follows is a series of observations about corporations, ethics, and corporate culture.



### TERM TO KNOW

#### Corporate Culture

The shared values, interests, standards, and beliefs that naturally evolve among the members of a corporation; the culture is influenced by the group's shared goals and experiences.

### 1a. Ethical Leadership Is Top-Down

People in an organization tend to watch closely what the top managers do and say. Regardless of managers' talk about ethics, employees quickly learn what speech or actions are in fact rewarded.

If the CEO is firm about acting ethically, others in the organization will take their cues from him or her. People at the top tend to set the target, the climate, the beliefs, and the expectations that fuel behavior.

## 1b. Accountability Is Often Weak

Clever managers can learn to shift blame to others, take credit for others' work, and move on before "funny numbers" or other earnings management tricks come to light.

Too often, we see that the manager is often an agent for himself or herself and will often act more in his or her self-interest than for the corporate interest.

This is not much different in politics, however, where we see elected officials **self-deal**.



### TERM TO KNOW

#### Self-Dealing

In business, a departure from a duty of loyalty to another in favor of oneself. For example, an officer of a corporation who is a fiduciary with a duty of loyalty to the corporation would be guilty of self-dealing if he or she set up a side business that competed with the corporation.

## 1c. Killing the Messenger

When organizations no longer function properly, some employees are inevitably unhappy. If they call attention to problems that are being covered up by coworkers or supervisors, they bring bad news.

Managers like to hear good news and discourage bad news. Intentionally or not, those who told on others, or blew the whistle, have rocked the boat and become unpopular with those whose misdeeds they report on and with the managers who don't really want to hear the bad news.

In many organizations, "killing the messenger" solves the problem.

⇒ **EXAMPLE** James Alexander at Enron Corporation was deliberately shut out after bringing problems to CEO Ken Lay's attention. When Sherron Watkins sent Ken Lay a letter warning him about Enron's accounting practices, CFO Andrew Fastow tried to fire her.

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## 2. Ethics Codes

Without strong leadership and a willingness to listen to bad news as well as good news, managers do not have the feedback necessary to keep the organization healthy.

Ethics codes have been put in place— partly in response to federal sentencing guidelines and partly to encourage feedback loops to top management. The best ethics codes are aspirational, having an ideal to be pursued, not legalistic or compliance driven.

⇒ **EXAMPLE** The Johnson & Johnson ethics code predated the Tylenol scare and the company's oft-celebrated corporate response. The corporate response - to sacrifice corporate profits and take the tainted



product off the shelves, recall the products, and offer free replacements - was consistent with that code, which was lived and modeled by the top of the organization.

It's often noted that a code of ethics is only as important as top management is willing to make it. If the code is just a document that goes into a drawer or onto a shelf, it will not effectively encourage good conduct within the corporation.

The same is true of any kind of training that the company undertakes, whether it be in racial sensitivity or sexual harassment. If the message is not continuously reinforced, or (worse yet) if the message is undermined by management's actions, the real message to employees is that violations of the ethics code will not be taken seriously, or that efforts to stop racial discrimination or sexual harassment are merely token efforts, and that the important things are profits and performance.

⇒ **EXAMPLE** The ethics code at Enron seems to have been one of those “3-P” codes that wind up sitting on shelves— “Print, Post, and Pray.” Worse, the Enron board twice suspended the code in 1999 to allow outside partnerships to be led by a top Enron executive who stood to gain financially from them.

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## 3. Federal Sentencing Guidelines

The federal sentencing guidelines were enacted in 1991. The original idea behind these guidelines was for Congress to correct the lenient treatment often given to white-collar, or corporate, criminals.

The guidelines require judges to consider “aggravating and mitigating” factors in determining sentences and fines. While corporations cannot go to jail, their officers and managers certainly can, and the corporation itself can be fined. Many companies will claim that it is one bad apple that has caused the problem; the guidelines invite these companies to show that they are in fact tending their orchard well.

They can show this by providing evidence that they have:

- A viable, active code of ethics
- A way for employees to report violations of law or the ethics code
- An ethics ombudsman, or someone who oversees the code

In short, if a company can show that it has an ongoing process to root out wrongdoing at all levels of the company, the judge is allowed to consider this as a major mitigating factor in the fines the company will pay.



### DID YOU KNOW

Most Fortune 500 companies have **ethics hotlines** (a way to call in ethics violations anonymously, avoiding any risk of “killing the messenger”) and processes in place to find legal and ethical problems within the company.



### TERM TO KNOW

**Ethics Hotline**

An identified telephone number or other mode of communication that provides a confidential means for employees or other stakeholders to report unethical conduct.

## 4. Managing by the Numbers

If you manage by the numbers, there is a temptation to lie about those numbers, based on the need to get stock price ever higher.

⇒ **EXAMPLE** At Enron, “15 percent a year or better earnings growth” was the mantra.

Jeffrey Pfeffer, professor of organizational behavior at Stanford University, observes how the belief that “stock price is all that matters” has been hardwired into the corporate psyche. It dictates not only how people judge the worth of their company, but also how they feel about themselves and the work that they are doing. And, over time, it has clouded judgments about what is acceptable corporate behavior.

An example of this phenomenon can be seen in the case below.

### **Managing by the Numbers: The Sears Auto Center Story**

Most people want to be winners or associate with winners. As humans, our desire to associate with those who have status provides plenty of incentive to glorify winners and ignore losers. But if an individual, a team, or a company does whatever it takes to win, then all other values are thrown out in the goal to win at all costs. The desire of some people within Sears Auto Center to win by gaining higher profits resulted in the situation portrayed here.

Sears Roebuck & Company was a fixture in American retailing throughout the twentieth century. At one time, people in rural America could order virtually anything (including a house) from Sears. Not without some accuracy, the company billed itself as “the place where Americans shop.” But in 1992, Sears was charged by California authorities with gross and deliberate fraud in many of its auto centers.

The authorities were alerted by a 50 percent increase in consumer complaints over a three-year period. New Jersey’s division of consumer affairs also investigated Sears Auto Centers and found that all six visited by investigators had recommended unnecessary repairs. California’s department of consumer affairs found that Sears had systematically overcharged by an average of \$223 for repairs and routinely billed for work that was not done. Sears Auto Centers were the largest providers of auto repair services in the state.

The scam was a variant on the old bait-and-switch routine. Customers received coupons in the mail inviting them to take advantage of hefty discounts on brake jobs. When customers came in to redeem their coupons, sales staffers would convince them to authorize additional repairs. As a management tool, Sears had also established quotas for each of its sales representatives to meet.

Ultimately, California got Sears to settle a large number of lawsuits against it by threatening to revoke Sears' auto repair license. Sears agreed to distribute \$50 coupons to nearly a million customers nationwide who had obtained certain services between August 1, 1990 and January 31, 1992. Sears also agreed to pay \$3.5 million to cover the costs of various government investigations and to contribute \$1.5 million annually to conduct auto mechanic training programs. It also agreed to abandon its repair service quotas. The entire settlement cost Sears \$30 million. Sears Auto Center sales also dropped about 15 to 20 percent after news of the scandal broke.

Note that in boosting sales by performing unnecessary services, Sears suffered very bad publicity. Losses were incalculable. The short-term gains were easy to measure; long-term consequences seldom are.

This case illustrates a number of important lessons:

1. People generally choose short-term gains over potential long-term losses.
2. People often justify the harm to others as being minimal or "necessary" to achieve the desired sales quota or financial goal.
3. In working as a group, we often form an "us versus them" mentality. In the Sears case, it is likely that Sears "insiders" looked at customers as "outsiders," effectively treating them (in Kantian terms) as means rather than ends in themselves. In short, outsiders were used for the benefit of insiders.
4. The long-term losses to Sears are difficult to quantify, while the short-term gains were easy to measure and (at least for a brief while) quite satisfying financially.
5. Sears' ongoing rip-offs were possible only because individual consumers lacked the relevant information about the service being offered. This lack of information is a market failure, since many consumers were demanding more of Sears Auto Center services than they would have (and at a higher price) if relevant information had been available to them earlier. Sears, like other sellers of goods and services, took advantage of a market system, which, in its ideal form, would not permit such information distortions.
6. People in the organization probably thought that the actions they took were necessary. Noting this last point, we can assume that these key people were motivated by maximizing profits and had lost sight of other goals for the organization.

The emphasis on doing whatever is necessary to win is entirely understandable, but it is not ethical. The temptation will always exist - for individuals, companies, and nations - to dominate or to win and to write the history of their actions in a way that justifies or overlooks the harm that has been done. In a way, this fits with the notion that "might makes right," or that power is the ultimate measure of right and wrong.

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## 5. Conscious Capitalism

One effort to integrate the two viewpoints of stakeholder theory and shareholder primacy is the conscious capitalism movement. Companies that practice conscious capitalism embrace the idea that profit and prosperity can and must go hand in hand with social justice and environmental stewardship. They operate with a holistic or systems view. This means that they understand that all stakeholders are connected and interdependent. They reject false trade-offs between stakeholder interests and strive for creative ways to achieve win-win-win outcomes for all.

The “conscious business” has a purpose that goes beyond maximizing profits. It is designed to maximize profits, but is focused more on its higher purpose and does not fixate solely on the bottom line. To do so, it focuses on delivering value to all its stakeholders, harmonizing as best it can the interests of consumers, partners, investors, the community, and the environment. This requires that company managers take a “servant leadership” role, serving as stewards to the company’s deeper purpose and to the company’s stakeholders.

Conscious business leaders serve as such stewards, focusing on fulfilling the company’s purpose, delivering value to its stakeholders, and facilitating a harmony of interests, rather than on personal gain and self-aggrandizement. Why is this refocusing needed? Within the standard profit-maximizing model, corporations have long had to deal with the “agency problem.” Actions by top-level managers - acting on behalf of the company - should align with the shareholders, but in a culture all about winning and money, managers sometimes act in ways that are self-aggrandizing and that do not serve the interests of shareholders.

Laws exist to limit such self-aggrandizing, but the remedies are often too little and too late and often catch only the most egregious overreaching. Having a culture of servant leadership is a much better way to see that a company’s top management works to ensure a harmony of interests.



## SUMMARY

In this lesson, you learned that common **observations on corporate culture** reveal that **ethical leadership is top-down, accountability is often weak**, and there can be a tendency to **kill the messenger**. To ensure that they are abiding by the law and acting responsibly, many corporations have instituted **ethics codes** as a response to **federal sentencing guidelines**, which place greater regulations on businesses.

A downfall of many corporations is the tendency to **manage by the numbers**, which often results in prioritizing profits over all else, regardless of the legal or ethical consequences. The **conscious capitalism** movement advocates for considering profitability in conjunction with social justice and environmentalism rather than separately from them.

Best of luck in your learning!

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## TERMS TO KNOW

### **Corporate Culture**

The shared values, interests, standards, and beliefs that naturally evolve among the members of a corporation; the culture is influenced by the group's shared goals and experiences.

### **Ethics Hotline**

An identified telephone number or other mode of communication that provides a confidential means for employees or other stakeholders to report unethical conduct.

### **Self-Dealing**

In business, a departure from a duty of loyalty to another in favor of oneself. For example, an officer of a corporation who is a fiduciary with a duty of loyalty to the corporation would be guilty of self-dealing if he or she set up a side business that competed with the corporation.

# Minimizing Corporate Criminal Liability

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about specific strategies and laws that can help combat crime in the business world. Specifically, this lesson will cover:

1. [Ethics Codes and Hotlines](#)
2. [Protection of Whistleblowers](#)

## 1. Ethics Codes and Hotlines

Businesses can take steps to reduce the potential for criminal liability. Likewise, individuals do not have to sit by passively if they know that criminal activity is afoot.

Businesses should conduct annual training sessions, such as ethics training, to help ensure good workplace ethics. As you learned in an earlier lesson, they should also develop company-wide **codes of ethics**, which serve as the organizational commitment to ethical behavior.

This can go far toward developing a corporate culture that values ethical behavior and condemns unethical actions, by providing leadership that serves as positive role models for all employees.

Some companies, such as Boeing, have even instituted an **ethics hotline**, which allows employees to anonymously report unethical behavior so that it can be investigated.

Additionally, **federal sentencing guidelines** in place for organizations state that organizations that maintain a rigorous compliance program to detect and report violations of the law, and voluntarily disclose those violations when they occur, are eligible for significantly reduced sentences and fines.



## TERMS TO KNOW

### Code of Ethics

A set of rules created to guide honest conduct, often in business.

### Ethics Hotline

An identified telephone number or other mode of communication that provides a confidential means for employees or other stakeholders to report unethical conduct.

### Federal Sentencing Guidelines

## 2. Protection of Whistleblowers

Sometimes, of course, things still go wrong. A person who observes illegal behavior in the workplace may choose not to participate in that illegal behavior. Such a person can even choose to become a **whistleblower**.

Whistleblowers are people who report the illegal activity of their employers or organization to authorities. Typically, the whistleblowers have observed some wrongdoing that may harm others, and they decide to “blow the whistle” to protect the potential victims or to simply stop the wrongdoing.

Whistleblowers face many challenges in the workplace, not the least of which is the stigma associated with blowing the whistle. Paradoxically, even though the whistleblower may be preventing harm to innocent people, other employees may view the whistleblower as someone who has betrayed the organization.

Because of this, whistleblowers are often placed in a terrible ethical dilemma, because while they may observe wrongdoing, they may not feel comfortable reporting the illegal activity. They may fear losing their job or not being able to find a new job. Prospects of losing one’s status, friends, or reputation can prevent many people from blowing the whistle, even though they may wish the behavior to stop.

Whistleblower protection laws prohibit **retaliation** against whistleblowers. Certain statutes also contain whistleblower protection provisions.

### IN CONTEXT

The Sarbanes-Oxley Act contains whistleblower protection, but the statute is not entirely devoted to whistleblower protection.

The False Claims Act provides that anyone who blows the whistle on a federal contractor committing fraud on the government can personally receive a portion of any amount recovered, up to 25 percent.

Check out the [Whistleblower Law Blog](#), which lists many of the statutes under which whistleblower protections are offered.

Despite these protections, many real-world whistleblowers have discovered that the laws are cold comfort for the realities that face them after a whistle is blown.

Corporations can also avail themselves of **safe harbor** provisions in certain statutes. If they see criminal behavior and realize that they may be implicated in the criminal behavior, they can report certain actions to authorities, which will allow them to receive a lesser penalty, or no penalty at all. Only a few criminal statutes have safe harbor provisions, however.



## TERMS TO KNOW

### Whistleblower

The designation given to a person who reports wrongdoing in an organization in order to stop it, typically pursuant to a statute or rule that also provides protection from retaliation to the whistleblower.

### Retaliation

The act of taking revenge. In employment law, employers can be prohibited under certain laws for firing, demoting, or otherwise applying adverse employment actions against individuals who claim rights against the employer or whistleblow.

### Safe Harbor

In certain situations, a law that provides relief from liability so long as particular conditions are met.



## SUMMARY

In this lesson, you learned that businesses can encourage ethical behavior in the workplace to help employees avoid illegal behavior through **ethics codes and hotlines**, training seminars, and ethical leadership.

**Whistleblower protection** laws and provisions also encourage ethical behavior by prohibiting retaliation against whistleblowers. However, whistleblowers often experience negative consequences when they report the illegal activities of their organization to the authorities despite these laws.

Best of luck in your learning!

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## TERMS TO KNOW

### Code of Ethics

A set of rules created to guide honest conduct, often in business.

### Ethics Hotline

An identified telephone number or other mode of communication that provides a confidential means for employees or other stakeholders to report unethical conduct.

### Federal Sentencing Guidelines

A set of non-binding rules established for federal criminal sentencing under the Sentencing Reform Act of 1984 in order to make sentences uniform and consistent in the federal system.



**Retaliation**

The act of taking revenge. In employment law, employers can be prohibited under certain laws for firing, demoting, or otherwise applying adverse employment actions against individuals who claim rights against the employer or whistleblower.

**Safe Harbor**

In certain situations, a law that provides relief from liability so long as particular conditions are met.

**Whistleblower**

The designation given to a person who reports wrongdoing in an organization in order to stop it, typically pursuant to a statute or rule that also provides protection from retaliation to the whistleblower.

# Terms to Know

## **Abuse of Discretion**

A judge's failure to exercise sound and reasonable discretion; an error of law by the court.

## **Administrative Law**

A body of laws put in place by unelected government officials, also known as rules and regulations by a government agency.

## **Admiralty**

The area of law that deals with ships, the sea, or other navigable waters.

## **Adversary System**

The legal system in use in the U.S. whereby courts hear evidence from parties in a case who advocate for themselves, while the judge acts as an independent arbiter of the facts and law. Distinguished from the inquisitorial system where the judge investigates.

## **Affirm**

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court affirms the lower court's decision, the appellant has lost the appeal.

## **Alternative Dispute Resolution (ADR)**

A means of resolving disputes outside of the judicial process, including but not limited to negotiation, mediation, arbitration, neutral evaluation, conciliation conferences, settlement conferences, and the like.

## **Amount in Controversy**

The amount of money involved in a civil claim brought in a federal district court to determine if diversity jurisdiction can be asserted.

## **Appellant**

The party who appeals a court's decision.

## **Appellee**

The party who has not appealed a court's decision but must respond to the appellant's appeal. Also referred to as a respondent.

## **Arbitration**

A form of alternative dispute resolution in which a neutral third party (the arbitrator) acts as a judge to determine a legally binding solution to the conflict.

## **Articles of Organization**

The state filing required to start an LLC. For corporations, these are called articles of incorporation.

## **Beyond a Reasonable Doubt**

The standard of proof by which a criminal defendant must be found guilty in order to be convicted of a crime or misdemeanor.

## **Bicameral**

Legislative bodies such as Congress in the U.S. and Parliament in the United Kingdom that have 2 separate chambers. In the U.S., these are the House of Representatives and the Senate.

## **Business Judgment Rule**

A rule applied by courts that presumes that a business decision made by directors of a corporation is made in good faith that it is in the best interests of the company.

## **Choice of Law**

In conflict of laws (as when laws of different states may apply), the choice by a court of which law should govern a case.

## **Closing Argument**

The concluding statement made by each party to a jury summarizing the evidence, law, and reasons why the jury should find in their favor.

## **Code of Ethics**

A set of rules created to guide honest conduct, often in business.

## **Color of Law**

The appearance of a legal right, without the substance; when a state actor takes illegal action, abusing power, but is clothed with the authority of the state.

## **Common Law**

Court-created law; the body of court decisions creating precedents by which future cases will also be decided.

### **Communitarianism**

A doctrine that emphasizes the effects of community and society on an individual's development, de-emphasizing individualism.

### **Complaint**

The document filed to bring about a lawsuit.

### **Concurrent Jurisdiction**

The jurisdiction of more than one court, each authorized to decide the same subject matter at the choice of the plaintiff.

### **Conflict of Laws**

An area of legal study of each state that determines which law applies when a case relates to the law of more than one state.

### **Congress**

The legislative body at the federal level.

### **Corporate Culture**

The shared values, interests, standards, and beliefs that naturally evolve among the members of a corporation; the culture is influenced by the group's shared goals and experiences.

### **Corporation**

A business that is chartered by state law and requires a uniform structure such as shareholders who elect a board of directors who then elect officers. Regular meetings of record are required. The owners of a corporation (shareholders) are not liable for the business. Only the corporation itself is liable for the business's debts and judgments.

### **Cross-Examination**

A procedure whereby the opposing side is allowed to question the other side's witnesses in a trial or deposition, usually limited in scope by the content of the direct examination in a trial.

### **Cruel and Unusual Punishment**

Punishment prohibited by the Eighth Amendment of the U.S. Constitution; punishment considered by societal norms as barbaric or torturous; punishment not known to the common law; punishment so disproportionate to the offense that it shocks the moral sense of society.

## **Deontology**

A doctrine in the study of ethics that looks at an action in isolation to determine if it is right or wrong, as opposed to looking only at its consequences.

## **Directed Verdict**

A verdict decided by the judge without advice from the jury, often occurring when the plaintiff (or prosecutor in a criminal case) has not presented sufficient evidence.

## **Directors**

The individuals who make up a corporation's board of directors. They are elected by the shareholders and are legally required to supervise the activities of the corporation as fiduciaries.

## **Diversity Jurisdiction**

A type of subject matter jurisdiction exercised by a federal district court under Article III, Section 2 of the U.S. Constitution allowing the court to take civil cases between citizens of different states. The amount in controversy must also exceed a certain amount, currently \$75,000.

## **Due Process**

Legal proceedings that are regular, orderly, and based on established principles for the enforcement and protection of rights.

## **En Banc**

A term referring to the entire panel of judges comprising a court. Typically, matters are heard by one judge or a panel of judges. A court will hear a matter en banc at its discretion, usually when a case is considered of particular importance.

## **Enabling Legislation**

Acts of Congress that create administrative agencies (typically serving under the executive branch of government) to carry out laws passed by Congress. This type of legislation allows the agency to only act consistently with such power to make rules, laws, and decisions as granted by Congress in the enabling legislation.

## **Ethics**

Moral principles that govern behavior and conduct.

## **Ethics Hotline**

An identified telephone number or other mode of communication that provides a confidential means for employees or other stakeholders to report unethical conduct.

## **Executive Branch**

In the U.S., the executive branch is the US President, cabinet, and agencies, and staff. The purpose of the executive branch is to carry out all of the laws of Congress.

## **Federal Question**

A type of subject matter jurisdiction giving federal courts the power to hear questions of federal law.

## **Federal Sentencing Guidelines**

A set of non-binding rules established for federal criminal sentencing under the Sentencing Reform Act of 1984 in order to make sentences uniform and consistent in the federal system.

## **Federalism**

The U.S. system of government whereby a separate federal sovereign, the federal government, exists simultaneously with individual, sovereign states as one political system.

## **Fiduciary**

The legal status of a person who is obligated to act in another's best interests, similar to a trustee, with a high degree of care, honesty, and trust.

## **Franchise**

The owner of intellectual property (patents, licenses, trademarks, etc.) who offers to franchisees (individuals or businesses) the use of its protected business ideas to operate a commercial enterprise under the name and mark of the owner.

## **Franchisor**

A company (such as McDonald's) that enters into a contract with a franchisee (an individual or business) to use the franchisor's intellectual property (patents, licenses, trademarks, etc.) and operate a business as part of the franchise (such as an individual McDonald's restaurant).

## **General Jurisdiction Courts**

Courts that can hear cases about any dispute or controversy unless such disputes can only be heard in a court of special jurisdiction, such as a bankruptcy or case.

## **General Partnership**

An unincorporated association formed by two or more individuals to carry on business, both of whom are personally liable for all debts of the partnership.

## **Goodwill**

In business, the intangible qualities of a business that give it a good reputation; goodwill is considered to have monetary value.

## **Harmless Errors**

Errors made by a judge at trial that are deemed not to have any meaningful effect on the appellant's rights.

## **Hung Jury**

A jury that is unable to agree on a verdict.

## **In Personam**

A Latin term used in law to refer to personal jurisdiction.

## **Insolvency**

The financial inability by a debtor (individual or business) to pay debts as they come due.

## **Intellectual Property**

A type of personal property derived from a person's creativity, such as a patent, trademark, copyright, etc.

## **Intermediate Appellate Courts**

Courts of appeal that are not the final appeals court in a particular jurisdiction. In the federal system, these are called circuit courts of appeal (the Supreme Court being the final appeal).

## **Joint and Several Liability**

Liability characterized by the ability of a creditor to sue one or all of the parties at the creditor's option.

## **Josephson's Core Values Model**

A process to arrive at the most ethical option for an individual or a business organization, using a virtue ethics approach combined with some elements of stakeholder analysis and utilitarianism.

## **Judgment Notwithstanding the Verdict**

Also known as judgment n.o.v., a judgment entered by order of court at the end of a proceeding, despite a contrary verdict.

## **Judicial Branch**

In the U.S., the judicial branch of government is the federal court system. Its purpose is to enforce the laws of Congress by addressing cases and controversies that come before it.

## **Judicial Notice**

The custom allowing a judge to take notice of events that are commonly known, such as the weather or a well-known event, without having to take in evidence of same.

## **Judiciary**

The branch of government responsible for courts; the judges on a court.

## **Jurisdiction**

A general term referring to the power and authority of a court; areas of authority including geographical areas covered by a court as well as subject matter areas and the ability to determine personal rights.

## **Jurisprudence**

The philosophy, science, or study of law.

## **Law**

A set of rules that are enforced by a government authority.

## **Legal Positivism**

A system of jurisprudence that holds that law is socially constructed based on norms of society. It can be contrasted with a system such as natural law, which believes laws are based on morals that are unchanging and determined by nature, not man-made.

## **Legal Realism**



A system of jurisprudence that holds that law is constructed by law makers (courts and legislatures) for the good of society and does not come from any supernatural source.

## **Legal Reasoning**

Reasoning done using several methods, the most basic of which is the syllogism: A conclusion is drawn from the premises. The premises are the facts and the rule of law that applies to such facts. Together, they form a logical conclusion. Example: All motorists are required by the law to stop at the stop sign. Joe did not stop but drove straight through the stop sign. Therefore, Joe broke the law.

## **Legislative Branch**

In the U.S., the legislative branch is known as the Congress and is composed of the House of Representatives, elected every 2 years, and the Senate, elected every 6 years (in staggered terms so that 1/3 of the body is elected every 2 years). The purpose of Congress is to pass federal laws.

## **Limited Jurisdiction**

Limitations on the subject matter courts can hear and determine.

### **Limited Jurisdiction Courts**

Courts with limited subject matter jurisdiction such as bankruptcy, family, small claims courts, traffic court, probate courts, etc. Unlike general jurisdiction courts, these courts derive their limited authority from a specific provision in a statute or constitution.

## **Limited Liability**

A limitation on a person's financial liability. In business, this refers to a corporation or a limited liability company (LLC). When one of these entities is sued, the owners of the corporation (shareholders) or of the LLC (members) are typically not liable at all for the acts of the company and only their investment in the company is at stake, not their personal wealth.

### **Limited Liability Company (LLC)**

A hybrid between a corporation and a partnership in that it is a separate entity but has fewer formalities than a corporation. It is a simpler form of entity than a corporation but also has limited liability of its owners like a corporation, and unlike a partnership. It can only be formed under state law.

### **Limited Liability Partnership (LLP)**

A form of business organization that allows the partnership to pass through income for tax purposes, but retain limited liability for all partners.

### **Limited Partnership**

An unincorporated association formed by two or more individuals to carry on business, and at least one partner is relieved of personal liability for the debts of the partnership, in compliance with special state laws that allow this. The limited partner's liability is limited to his or her investment in the partnership.

### **Long-Arm Statute**

A state law that provides for personal jurisdiction over defendants in foreign states. For example, doing business in a state is one category states have determined allow them to use their "long arm" to require an out-of-state defendant to appear in their court. Therefore, a corporation like Sears, headquartered in one state, may be required to defend actions in other states where it does business.

### **Mediation**

A form of alternative dispute resolution in which a trained professional (the mediator) attempts to resolve a dispute by listening to the parties, facilitating discussion, and helping find a solution to the problem.

### **Mistrial**

A trial declared to be invalid due to an error in the proceedings.

### **Modify**

One of several potential outcomes of an appeal of a court decision to a higher court. The appeals court has the ability to modify, or change, the decision of the lower court, while keeping parts of the decision.

### **Natural Law**

A system of jurisprudence that holds that law is based on a body of unchanging principles brought forth by the nature of human beings and their environment.

### **Negotiation**

A form of alternate dispute resolution in which the parties attempt to work directly with each other to resolve a dispute without the use of a third party.

### **Objection**

A formal challenge by a party to an offer of evidence or testimony by the opposing side in a trial.

## **Officers**

The individuals appointed by a corporation's board of directors to be in charge of a corporation as fiduciaries. Officers have a duty of loyalty to the corporation and the authority to make day to day decisions to manage the corporation and delegate authority.

## **Opening Statement**

The statement each side of a lawsuit makes to a jury to introduce the case.

## **Operating Agreement**

The contract between members of an LLC.

## **Partnership**

An unincorporated business formed by two or more individuals to make a profit.

## **Pendent Jurisdiction**

The type of discretionary jurisdiction a federal court takes over a related matter when it has original jurisdiction over a federal law claim where both claims arise from the same facts.

## **Peremptory Challenge**

The right of a party to challenge a juror without giving a reason. This right is limited to a particular number of challenges.

## **Perks**

Also known as perquisites; the incidental benefits that come with a job, such as travel opportunities, an expense account, a company car, and the like.

## **Personal Jurisdiction**

The authority a court has over a person being sued. The U.S. Constitution requires that in order for a court to have power over a person, that person must have minimum contacts with the forum (geographical area covered by the court). A court lacking personal jurisdiction over someone cannot issue a judgment against that person.

## **Piercing the Corporate Veil**

A judicial process in which a court disregards the protection from personal liability of a corporations' officers, directors, or shareholders when incorporation is viewed as solely for

the purpose of perpetuating fraud.

### **Positive Law**

A body of human-made laws that regulate conduct.

### **Precedent**

A previous decision made by a court that serves as a basis for decisions going forward. In future cases where the same or similar set of facts and legal issue are presented, the court will typically follow the precedent.

### **Prejudicial**

A judge's errors at trial that substantially affect an appellant's legal rights.

### **Preponderance of the Evidence**

A standard of proof whereby a fact is proven in civil cases; such evidence is of greater weight or more convincing than the evidence offered in opposition to it. Distinguished from "beyond a reasonable doubt," the standard in criminal cases.

### **Primary Sources of Law**

Sources of law issued by courts, legislatures, government agencies, and other sources that create law, including published court decisions, statutes, court rules, government agency decisions, and the like.

### **Procedural Law**

Also called adjective or remedial law, the rules that govern the method of enforcement of substantive law.

### **Public Policy**

Generally accepted principles, mostly unwritten, on which society generally agrees. Occasionally, a court will base a decision on public policy concerns rather than black letter law.

### **Rebuttal**

A witness whose testimony is given for the purpose of contradicting prior evidence, or testimony presented by a witness for the other side in a trial.

### **Recross-Examination**

The procedure whereby the side that performed cross-examination is allowed to conduct another examination of a witness limited to matters that came up on redirect examination in a trial. There is no limit to how long these processes may continue.

### **Redirect Examination**

The procedure whereby the side that first testified on direct examination is allowed to conduct another examination of a witness limited to matters that came up on cross-examination in a trial.

### **Removal**

The procedure in federal district court whereby a civil action brought in state court may be transferred to federal court so long as the federal court has subject matter jurisdiction.

### **Res Judicata**

A matter that has been adjudicated and finally decided; a rule that once a case is finally decided, it cannot be brought again.

### **Restatements of the Law**

Treatises on legal subject areas written by known legal scholars and published by the American Law Institute, containing a summary of primary sources of law for the purpose of stating the law in one volume. Although the restatements are a secondary source of law, they are so well-respected that courts and legal scholars view them almost as if they were primary source of law.

### **Retaliation**

The act of taking revenge. In employment law, employers can be prohibited under certain laws for firing, demoting, or otherwise applying adverse employment actions against individuals who claim rights against the employer or whistleblow.

### **Reverse**

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court disagrees with the lower court's decision, it will reverse it, or will reverse it in part, making void the part of the decision the appeals court found to be incorrect.

### **Reverse and Remand**

One of several potential outcomes of an appeal of a court decision to a higher court. When the appeals court reverses the lower court decision, it will often remand the case to the lower

court, with instructions on how to decide the case. Remand may also require the trial court to take in more evidence.

### **Rule Utilitarianism**

A form of utilitarianism that looks at a rule and determines its rightness based on utilitarian principles that consider its usefulness.

### **Rules of Evidence**

Court rules governing the admissibility of evidence at trial.

### **Safe Harbor**

In certain situations, a law that provides relief from liability so long as particular conditions are met.

### **Secondary Sources of Law**

Sources of law that are written by those who discuss the law that comes from primary sources.

### **Self-Dealing**

In business, a departure from a duty of loyalty to another in favor of oneself. For example, an officer of a corporation who is a fiduciary with a duty of loyalty to the corporation would be guilty of self-dealing if he or she set up a side business that competed with the corporation.

### **Service of Process**

The act of serving a defendant with legal process, dictated by the rules of procedure of a particular court.

### **Shareholder**

A human being or corporate entity that owns stock in a company but has no legal right to the company's assets.

### **Shareholder Derivative Lawsuit**

A lawsuit brought by a shareholder on behalf of the corporation against a third party. Normally an officer would do this, but when he or she fails to take needed action, a shareholder may step in.

### **Shareholders**

The individuals or entities who own shares of stock in a corporation. They have the right to vote to influence actions of the corporation.

### **Significant Contact**

The requirement for a court's personal jurisdiction over a defendant; such jurisdiction is not permitted where the defendant does not have at least minimum contact with the jurisdiction where the court is located.

### **Social Justice**

A doctrine in the study of ethics that considers distribution of wealth, privileges, and opportunities in a society rather than the good of individuals.

### **Sole Proprietorship**

A business that is owned by one individual alone. This business and the individual who owns the business are one and the same and there is no separation between them, and the owner is fully liable for the business.

### **Stakeholders**

A general term referring to persons or organizations who have an interest in a particular matter. For example, the stakeholders interested in whether or not a bar or liquor store can be located in a particular location would be workers, businesses, the community at large, the owner of the proposed business, and law enforcement.

### **Stare Decisis**

Latin term referring to the doctrine courts apply to case law to adhere to precedents; to follow rules made by prior decisions and not to unsettle things that have already been established.

### **Statute**

An act of a legislature declaring, requiring, or prohibiting something. Also known as a law.

### **Statute of Limitations**

A statute that limits the time within which an action can be filed in court.

### **Statutory Law**

Law created by a legislative body.

### **Stock**

A share of a corporation.

### **Stock Option**

A purchased privilege (but not an obligation) to buy a stock at a certain price within a prescribed period of time.

### **Subject Matter Jurisdiction**

A court's power to hear and determine cases of a certain class or category of cases.

### **Substantive Law**

The part of law that defines, creates, and describes rights and duties (as opposed to the procedural laws that merely govern how substantive laws are enforced.)

### **Term Limit**

A legal limitation to the number of terms a particular officeholder may serve in a particular public office.

### **U.S. Magistrate Judges**

Federal judges serving in the U.S. District Court under a district court judge. District court judges are appointed for life, while magistrate judges are appointed for limited terms and can only hear cases assigned to them by the district court judges.

### **Uniform Commercial Code (UCC)**

A uniform act relating to commercial law that has, over time, been adopted in all 50 states, the District of Columbia, and US territories. It is not a federal law, but its adoption throughout the US makes interstate commercial transactions harmonious, although not all states have adopted all parts of the UCC.

### **Utilitarianism**

A doctrine in the study of ethics that considers actions that are useful or most beneficial to the majority to be the right actions (as opposed to other doctrines that consider the acts themselves in isolation from their utility or benefits).

### **Venue**

A particular place, county, or geographical area where a court is located.

### **Virtue Theory**



A theory in the study of ethics that emphasizes character and virtue over duties or consequences of actions. Examples are Aristotle's virtues of integrity, empathy, warmth, courage, conscientiousness, and zeal.

### **Waiver**

The relinquishment of a right to object to evidence in court if a timely objection is not made.

### **Whistleblower**

The designation given to a person who reports wrongdoing in an organization in order to stop it, typically pursuant to a statute or rule that also provides protection from retaliation to the whistleblower.

### **Writ of Certiorari**

An order by an appellate court (typically a Supreme Court) used when the court has discretion whether or not to take an appeal. If the writ is denied, the judgment below stands. If the writ is granted, the appeal will go forward.